FEDERAL FINANCE AND ECONOMIC DEVELOPMENT IN INDIA

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PREFACE

This study is essentially concerned with the analysis of the role of fiscal dynamics in the achievement of balanced regional development of the Indian economy.

It has tried to evaluate the scheme of resource allocation as determined by the structure of Indian public finances in the context of planned economic development of the Indian economy.

The process of economic growth is a function of a complex factor both economic and non-economic. This explains why the theoretical models of economic growth built upon mechanistic assumptions fail to explain fully the process of economic growth of an economy. The role of Government in the process of growth of both the developed and developing countries has tended to increase and thus the structure of Government and its decisions determining the allocation of resources in the economy become of fundamental importance in this process. In the Indian economy this problem has acquired an increasing importance because of the predominant role of the Government in the process of development planning and implementation of development plans.

The problem of allocation of resources in the context of the planned economic development of the economy has acquired increasing importance because there has developed a growing imbalance between the needs for resources and their availability in the different regions of the country. This has called for evolving a rational plan of resource allocation with a view to achieving a balance in levels of development among the different States.

Some of the materials used in the preparation of this work were collected during my studies in London at the India House Library, the Library of the London School of Economics and Political Science and the Senate House Library of the University of London and I am deeply thankful for the courtesy and consideration I received in these libraries.

R.N. Tripathy

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INTRODUCTION

This work is essentially a study in the economics of fiscal dynamics in the context of economic growth. In accordance with the Figovian criteria of public finance, the federal government is called upon to redistribute the national resources from the low income States to the high income ones of a federal country in order to make the entire system of public finance of the country conform to the ideal of utilitarian optimum. But it has been maintained that the maxims of utilitarian finance do not provide a correct guidance and criterion of fiscal policy for the redistribution of resources in the context of economic growth. In this context, the redistribution of national resources through the fiscal policy of the federal government should have the objective of maximizing the rate of economic growth and should be based upon the criterion of marginal productivity. Thus, a position of optimum allocation of resources may not be compatible with the redistributive ideals of federal finance aimed at the equalisation of incomes in the different states of a federal system. This implies that the mechanism of federal grants should be guided by the objective of maximising economic growth and should be fitted into the larger framework of a development plan in a growing economy.

But the achievement of inter-regional balance in economic development constitutes an important aspect of development planning and resource allocation in a developing economy. The existence of large disparities in the levels of development in the different regions of a country creates serious economic problems tending to the flow of resources from the less developed regions to the more-developed ones, thus creating depressed areas and frustrating the goals of development. There can, however, be a conflict between the objective of accelerating the rate of economic growth and of the achievement of regional balance in development in the initial stages of the planning process. But the planning techniques and the pattern of resource allocation must aim at the achievement of regional balance as the long-term objective of development planning.

In a developing economy, the instrument of public finance

is called upon to play a positive and dynamic role. In a growing economy with a federal structure of public finance, it is necessary that there should be a concerted and co-ordinated operation of fiscal policy for planning the allocation resources, for the mobilisation of resources and for the implementations of the plan of investment. This calls for the establishment of an effective machinery for national planning and for the co-ordination of development policy of the federal and state governments. At the same time, there should be an adequate and effective administrative machinery at each level for a successful implementation of the national plan. Besides, if a federal system is to be compatible with the criteria of effective planning, there should be adequate and efficient planning institutions at the regional and base levels also. Democratic planning does not demand outright centralisation of the structure of public finance in a growing economy. Effective planning at the national, regional and base levels should go side by side with a decentralised implementation of the development plan.

The organisational structure of Indian planning has been critically studied and its inadequacies and imperfections brought into bold relief. It has been maintained that the institutional structure of Indian planning to be adequate and complete requires the establishment of effective planning organisations at the state, regional and base levels under the guidance of the Planning Commission at the Centre.

An analytical study has been made of the economics of resource mobilisation during the Five-Year Plans in India and the lessons it can provide for the future Plan and the weakness and the strength of the federal structure of public finance has been assessed in this regard.

The main focus of the study in this regard has been to analyse the compatibility of the structure of Indian public finance with the requirements of fiscal policy suited to a developing economy.

The fiscal impact of federalism in India in the context of a process of planned economic development has been analysed and it has been found that there has been taking place a considerable transference of resources from the Centre to the states; and the public expenditure policy of the states is dependent, to a large extent, on such a resource transfer.

But this has fundamentally altered the structure of Indian public finance. The extent of disparities in the levels of economic development of the different states in India has been assessed. The disparities in the levels of economic development in the different states have been found to be a function of a large number of factors, but the role of the public finance system of the country has been especially highlighted in this regard. The policy of resource transfers from the Centre to the state has been subjected to a critical examination from the point of view of removing the disparities in the resources of the various states. In this connection, the policy of Central financial assistance to the states to finance the Five-Year Plans and the system of grants recommended by the Finance Commissions have come in for a critical review from the point of view of the need of promoting balanced regional development.

Finally the study has summed up the basic issue in Indian federal finance and has suggested broad guidelines for their solution in the larger context of the requirements of balanced regional growth in the economy.

THEORY OF FEDERAL FINANCE IN A DEVELOPING ECONOMY

A federal structure of public finance, characterised by the existence of constituent states at various levels of development, is considered incompatible with the criteria of the redistributive ideals of public finance aimed at maximising the aggregate utility of satisfaction of the community. Therefore, in accordance with the criteria of redistributive finance, the federal government should elect to transfer resources from the high-income states to low-income ones so as to fill in the "gaps of unevenness as between one state and another."[1]

Fiscal policy as an instrument of economic development is essentially concerned with effecting transfers of resources from a line having lower marginal productivity to one having a higher one. Therefore, the transfer of resources from a high income state to a low income one will be compatible with the criteria of economic growth only if such a transfer results in a higher marginal productivity of the transferred resources.

The theory of federal finance formulated so far has kept in view the conditions of the developed countries with a high level of national output and volume of capital formation. In the developed countries, the redistributive and welfare ideals of public finance have a definite role to play in increasing the volume of satisfaction and utility in the economy. But in a developing country, the objective of maximising the rate of economic growth rather than the achievement of regional balance should be the guiding consideration in the transfer of resources from a high-income state to a low-income one through the apparatus of the fiscal policy of the federal government. In a developing country, the welfare consideration in fiscal policy has to be subordinated to the supreme objective of promoting and accelerating economic growth.

The objective of fiscal policy may be defined as the achievement of (a) utility optimum; (b) production optimum both considered in a dynamic sense.[2] The utility optimum partly depends upon the production optimum, and partly on the way in which the aggregate output is distributed in the community.

The condition of production optimum is attained when the allocation productive factors in the economy conforms to the principle of equi-marginal productivity; and when the productive factors are fully and continuously employed.

Fiscal policy as an effective instrument of economic planning can make an important contribution to the achievement of production optimum by regulating the flow of productive resources; and by removing the hindrance in the way of the most judicious allocation of these resources, such as the monopolistic control of markets and the existence of inadequate enviromental services and basic overheads. In terms of Keynesian economics, the role of fiscal policy as a compensatory instrument in the economy has to be viewed as contributing to the achievement of production optimum by enabling the maintenance of full employment.

Fiscal policy can make a contribution to the maximisation of aggregate utility by the redistribution of income in the community. This view of public finance involves the problems of inter-personal comparisons of utility and cardinal measurability of utility; and redistributive fiscal policy for maximising aggregate utility might have no scientific validity due to the difficulties of inter-personal comparisons of utility and its cardinal measurability. Besides, redistributive fiscal policy, if carried beyond a certain limit, might conflict with the objective of promoting economic growth and aggregate output in an economy.

The theoretical case for inter-regional transfers of resources through federal fiscal policy has been based upon the application of the fundamental principles of public finance to the special conditions obtaining in a federal polity characterised by the existence of marked heterogeneity in the levels of development in the constituent states. There is no such thing as an original theory of federal finance.

According to Prof. R.A. Musgrave "Federalism means different things to different people and so do its fiscal implications. No wonder then that there is no distinct theory of fiscal

federalism. Rather we deal with a composite of theories or models, pointed at various facts of the problem."[3]

According to the principles of utilitarian finance, the norm of the operation of the apparatus of public finance is the maximisation of aggregate social utility.[4] In terms of this principle of public finance, the ideal scheme of taxation for a country has to be conceived on the basis of the equalisation of marginal sacrifice of social utility as regards each economic unit. In the field of public expenditure, the norm of maximising aggregate social utility would be satisfied if the distribution of resources on each line is made on the basis of equality in marginal social utility. In terms of combined aggregate effects of taxation and public expenditure, aggregate social utility would be maximised when the marginal social utility from each line of government expenditure is equal to the marginal social disutility or loss of utility involved in raising the corresponding volume of taxes.

But in federal system marked by a combination of states with varying levels of development, even if each one of the governments, federal and state, follows the above principles of public finance, the maximisation of aggregate utility may not result.[5] The marginal sacrifice of social utility involved in state taxation may be higher in the poor states because of the low level of income and lower demand for public services there. The richer states will have a position of fiscal equilibrium at a lower point of marginal utility and disutility than the poorer ones. Therefore, a transference of resources from the richer to the poorer states through the apparatus of federal finance will result in an addition to aggregate social utility and the eqaalisation of marginal social utility and disutility for the economy as a whole.

But the theoretical case for inter-regional transference of resources through federal finance, based upon the utilitarian view of public finance, involves the problems of inter-personal comparisons of utility and measurability of utility in objective terms. There appears to be no scientific validity for any objective measurement of utility as well as comparability of inter-personal utilities. Thus it would be extremely difficult, if not impossible, to translate the theoretical implications of utilitarian finance in terms of exact policy prescriptions. As J.M. Buchanan put it, "it becomes extremely arduous, if not impossible, to fill

in the theoretical framework with empirical content."[6]

J.M. Buchanan has attempted to build up a theoretical case for inter-regional transference of resources through federal policy on the basis of the concept of fiscal justice.[7] The operation of the fiscal mechanism imposes a subtraction of resources on each individual as well as confers benefits on him. Therefore, in order to determine whether equals are treated equally, the aggregate fiscal pressure or fiscal residuum, i.e., the burden of taxes and the corresponding benefits of public expenditures of equals have to be compared.[8]

In a federal system, each individual feels the impact of two fiscal systems, viz., federal and state. If there be no differences in inter-state fiscal capacity, treatment of equals by the federal and state government in their respective fiscal spheres, will result in a combined equal treatment of equals and the fiscal structure of the country as a whole will tend to conform to the principle of fiscal equity. It states are not identical in fiscal capacity, the people in low-capacity states will be subjected to greater fiscal pressure. They may have a higher tax burden or a lower level of public services than people in high capacity states. If equals are thus pressed more in one area than in another, there will be provided an incentive for the migration of resources into the areas of least fiscal pressure. For an ideal allocation of resources, it is necessary that the fiscal system should be geographically neutral. But an unequal fiscal pressure in a federal state will hinder the allocation of resources in the economy from the point of view of higher marginal productivity and so prevent the maximisation of national output.

Therefore, the principle of fiscal equity as applied in the case of a federation requires that the Central Government should take action to transfer funds from high-capacity areas to low-capacity areas in order to equalise the fiscal pressure on equals living in different states. "The Central financial authority must enter the process and treat equals unequally in order to offset the divergences in the income and wealth levels of the subordinate units."[9]

The theoretical case for inter-regional transference of resources based upon the concept of fiscal equity also appears to suffer from certain fundamental limitations. This concept of fiscal equity is based upon the *quid pro quo* idea of public

finance which is not acceptable in the modern state due to the important role of the apparatus of fiscal policy both as an instrument of economic development and economic stabilisation. Besides, there is no precise method of imputing shares of the aggregate common benefits from public services to specific individuals. A significant portion of public funds is expended for the general welfare and not to benefit particular persons or groups. As a practical matter, there is no way in which the costs and benefits of activities which benefit the community as a whole can be measured. Thus, the policy implications of the theory of inter-regional transference of resources based upon this concept of fiscal equity cannot be translated into precise quantitative terms.

Inter-regional Transference of Resources in a Federal Structure and Economic Growth

Fiscal policy as an instrument of economic development has to transfer resources from a line having lower marginal productivity to one having a higher one. It is maintained that the transfers of government income from a high-income state to a low income one through federal fiscal policy tend to counteract the "incentive to labour mobility and thus prevent the maximisation of national production."[10]

On the other hand, it has been maintained that "it cannot be stated that income transfers from the high-income to the low-income areas will tend to retard the movement of resources towards their most productive employments. In each case, the results will depend upon the way in which the transfer is carried out and the relative importance of the off-setting effects on different resource categories. In most cases, the transfers seem to have the effect of encouraging the flow of resources in the direction indicated to be desirable by market criteria."[11]

The validity of the above contentions depends primarily upon the model of a low-income state which is taken into consideration. Scott's assumption as regards the model of a low-income state was that both national resources and other factors are scarce and that national product will be highest only when the scarce labour, capital and enterprise are attracted to the best soil, ports, mines, sites, etc., and that federal transfers will

frustrate this attraction unless such transfers are guided by the objective of maximising production.

Buchanan's model of the low-income state has been conceived in terms of the scarcity of capital, abundance of unskilled labour and equal endowment of other natural resources[12] and he thought his model to be the most" representative of reality."[13]

But both Scott and Buchanan appear to have erred on the side of taking extreme positions in visualising the model of the low-income state in a federal system. There might be states conforming closely to Scott's model; while there may be states conforming to Buchanan's model and there might be numerous individual variations conforming neither to the model of Scott nor to that of Buchanan.

The crux of the matter is that inter-regional transference of resources through federal policy tends to conform to the criterion of allocative efficiency and to the growth of the national output only to the extent to which such transference results in a higher marginal productivity of resources in the low-income states. The marginal productivity will be higher only to the extent to which such states have rich resource potentials waiting to be developed. In view of the existence of enormous heterogeneity in factor endowment in the different states, the considerations of allocative efficiency and economic growth appear to rule out complete equalisation in the levels of development among different states through the redistributive fiscal policy of the federal government.

But in a federal structure which is based essentially upon compromise, the criterion of allocative efficiency may not be the sole consideration in the policy of inter-regional transference of resources. The very nature of the federal organisation might compel to take other factors also into account such as "equity, national interest and the preservation of minimum standards of the public services",[14] as a result of which the inter-regional transference of resources may not conform to the criterion of allocative efficiency in each case.

Inter-regional Transference of Resources in a Developing Economy

It is maintained that the plan of economic development in

a developing economy must be guided by the objective of attaining regional or geographical balance in development.[15] But the consideration of attaining a higher rate of economic growth through the utilisation of the resources of the economy may not be compatible with the objective of regional balance especially in the initial phases of planned development. If each region of the economy be equally endowed with productive resources, the problem of regional balance would not present any serious difficulty. But in view of unequal endowment of resources, a developing economy has to give priority to the utilization of only those resources in the initial stages which yield a higher marginal productivity.

Therefore, in a developing economy characterised by the existence of scarcity of investible resources, the inter-regional transference of resources through the fiscal policy of the federal government should be motivated primarily by the consideration of maximising the rate of economic growth. This means that the federal government should give priority to those development projects of the states which yield a higher marginal rate of return in its policy of grants-in-aid and other kinds of fiscal assistance to the states. As a result, the redistributive ideals of public finance based either upon the utilitarian approach of maximising aggregate utility or upon the theory of fiscal equity have to be seriously limited in their application by the consideration of maximising the rate of economic growth.

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2

FISCAL POLICY IN A FEDERAL STRUCTURE

The Problems of Fiscal Policy in a Federal Structure

The effectiveness of fiscal policy in a federal structure both as an instrument of economic development as well as economic stabilisation tends to be seriously limited. As regards its use as an instrument of economic development, fiscal policy is essentially concerned with effecting transfers and allocation of resources necessary to maximise the growth of aggregate output. As an instrument of economic stabilisation it may operate as a compensatory factor to offset the behaviour of the private sector in the economy.

The limitations on the effectiveness of fiscal policy in a federal structure spring basically from the fact that (*a*) it is based upon the theory of the supremacy of the constitution invariably containing a charter of federal and state powers to which is sometimes added a constitutional guarantee of individual rights and liberties; and thus; (*b*) it results in a division of sovereignty under which constitutionally independent fiscal systems operate within a country. The doctrine of the supremacy of the constitution may be carried, for instance in the U.S.A., to such extremes that the judiciary functions as the arbiter over the respective competences of the federal and the state governments; and it may invalidate statutes. Therefore, all transfers of resources found necessary through the medium of public finance in order to maximise output are not permitted to the central government.

The above characteristics of federal constitutions have tended to weaken the effectiveness of fiscal policy through the operation of a number of important factors such as, (*a*) the

doctrine of public purpose in taxation, (*b*) the doctrine of reciprocal immunity from taxation of each other's instrumentalities, (*c*) the doctrine of uniform taxation, (*d*) the existence of discriminatory taxation of incomes, business and trade due to differences in state taxes, (*e*) the existence of tax barriers hindering the free flow of resources within the national economy, and (*f*) conflicting policies and measures of the State Governments.

In the U.S.A., the doctrine of public purpose in taxation was first used in the state courts during the first half of the 19th century to curb government expenditures in certain directions. It has since been modified in the constitutions of eleven states and forms part of the due process clause of the Fourteenth Amendment. The issue of public purpose has been raised in connection with acquisition of property, grants-in-aid, subsidies and assumption of new functions. Thus, it has not been easy to reconcile the function of fiscal policy as an instrument of economic development and economic stabilisation with the doctrine of public purpose in taxation.

According to the doctrine of uniform taxation, it has been maintained that the powers of taxation in a federal state should not be exercised in a discriminatory manner, i.e., (*a*) the burdens of federal taxes should be distributed uniformly on all states and (*b*) the states in their own turn should not discriminate between their citizens and those of other states. It has been interpreted by the courts that geographical uniformity, guaranteed herein, rules out even those variations in rates according to localities which are designed to make the ultimate incidence of taxes more uniform and to equalize the sacrifice between the tax payers in different localities.[1]

The existence of diverse and overlapping taxation of business and trade by the different states of a federal system tends to produce very adverse effects on economic growth. This problem still exists in the U.S.A., though its seriousness has been reduced, to some extent, by the increasing importance of central taxation in this field. As a result of discriminatory taxation of business and trade by the State in the U.S.A., it has been maintained that "the contribution of the State and local finance to the progress of the economy has not infrequently been negative."[2]

In Canada, before the complete assumption by the Dominion government of the power of taxation of income and business during the war, discriminatory taxation of industrial enterprises tended to produce very adverse effects on economic progress. As the Royal Commission on Dominion Provincial Relations put it, "they have grown up in a completely unplanned and uncoordinated way, and violate every canon of sound taxation."[3]

Free flow of resources within the national economy may be hindered by the existence of taxes imposed by states on interstate trade. But even when there are no such specific duties, commodity taxation by states, largely when states tax is supplemented by use tax, might be practised to create trade barriers disrupting the flow of resources in the economy.

In view of the existence of virtually two independent fiscal systems in a federal structure, there is always the possibility that the federal and state governments might follow conflicting policies. During the depression of 1930 in the U.S A., "the taxing, borrowing and spending activities of the state and local governments collectively ran counter to an economically sound fiscal policy,"[4] and this contributed to the deepening of the slump. The division of functions in the public sector between the central government and the local authorities even in U.K. proved a limiting factor in the planning and execution of an integrated public investment policy during the period of the depression.

The state and local governments tend to behave like private enterprise during business cycles. In a boom, they are buoyant with optimism, and tend to undertake a programme of expansion, thus adding fuel to the fire of inflationary expansion. In a slump, they are struck with gloomy pessimism, and tend to undertake a policy of contraction, thus adding to the deepening of the slump. Thus, left to themselves, these governments tend to follow "the swings of the business cycle, from crest to trough, spending and building in prosperity periods and contracting their activities during depression."[5]

The element of perversity imparted to the fiscal policies of the regional governments results from the fact that they tend to import the orthodoxies of personal finance into their fiscal behaviour. They function under serious limitation of taxing

and borrowing powers; and therefore, they always look to the current or short-term adequacy of their resources This leads them to follow a policy of balanced budgets, irrespective of the ups and downs of the business cycles. In addition, there seems to be a psychological reluctance on the part of the regional governments to undertake a compensatory fiscal policy. Since economic fluctuations are typically national in scope, it may seem not only useless, but also too costly for them to try to influence the course of the cycle. The individual action of each of these governments would be of meagre importance in influencing the course of the cycle, and the multiplier effects of their public spending policies would tend to spill over into other governmental areas due to geographic leakages.

Even in those federal countries in which private enterprise has played the leading part in the process of economic development, the central planning and direction of fiscal policy both for accelerating the pace of economic development and for achieving economic stabilisation at the level of full employment has acquired an increasing importance. But in these countries "increasing needs of central planning have come up against major constitutional obstacles or more precisely against psychological and political obstacles which have their origin in the federal constitutions."[6] Therefore, it has been held that the federal system in these countries (U.S.A., Canada, and Australia) has shown distinct signs of strain over a number of years. "The crux of the matter is that the needs of economic direction and social justice have shifted the balance of written constitutions enacted under different conditions. The scope and interrelations of powers thus framed have altered and this has brought into the open the latent contradiction of equal sovereignties."[7]

Therefore, it has been maintained that "within the highly organised modern state with its established minimum of planning powers and social duties, it (federalism) is out-of date"[8] and should be replaced by a completely unitary system.

But such a view of the incompatibility of central planning and direction of fiscal policy with the federal structure of public finance appears to have ignored the recent developments which have occurred in the field of federal finance, and which have tended to transform its structure in a remarkable manner. The

importance of these developments consists in the fact that they have tended to make the federal structure increasingly compatible with the needs for central planning and direction of fiscal policy both for the purpose of economic development as well as for economic stabilization.

These developments in the field of federal finance can be summed up in the shape of two important tendencies: (*a*) the remarkable growth of fiscal centralisation in the federal systems of the U.S.A., Canada and Australia; and (*b*) the transformation of the concept of federalism into one based upon that of co-operative federalism.

Besides, the replacement of a unitary fiscal structure in place of federal one in a country with a continental geographical dimension might be attended with economic inefficiency in the administration of fiscal policy. In a country where the people are not homogeneous in social outlook, traditions and economic interests, centralization in government must not go beyond "flexible limits". As Maxwell puts it, "the unitary and federal form of government cannot like a coat be assumed and dropped at will by any country. For some countries federalism is appropriate because only federalism is practicable."[9] As a result of the examination of the fiscal impact of federalism in the U.S.A., Maxwell came to the conclusion that "American federalism has fiscal problems for which outright centralisation is no cure."[10]

Moreover, the existence of the regional governments in the context of a federal structure of public finance has an important democratic value as providing "limited laboratories in which democracy can train itself in the art of government by carrying on political and economic experiments."[11]

Thus, the supreme necessity in a federal structure is to evolve a beautiful blending of the forces of centralisation and decentralisation in such a way that fiscal policy is made an effective instrument of economic development and stabilisation; and sufficient scope is given to the need for democratic expression and experimentation. This involves effective co-operation and co-ordination in all important spheres of fiscal policy, rather than replacement of the federal system by a unitary one.

The federal dilemma is being resolved in modern times through the emergence of the concept of "co-operative

federalism" which, instead of emphasising the rights, and independence of the states, approaches the federal problem essentially from the point of view of the division of labour rather than division of powers, with the objective of maximizing the effectiveness of fiscal policy.[12]

An Assessment of the Impact of Recent Developments on Fiscal Policy in some of the Federal Countries

In the sphere of public finance, the federal governments of Australia, Canada and the U.S.A. have steadily increased their powers at the expense of the states; and this increase in power and the predominant positions they now occupy have come about largely by the exploitation of powers granted to them by their constitutions. A number of factors have combined to contribute to the enormous growth of fiscal centralisation in these countries. As K.C. Wheare puts it, "power politics, depression politics, welfare politics and the internal combustion engine"[13] have tended to bring about this revolutionary transformation of the structure of federal finance in these countries.

The increasing growth of the process of industrialisation led to close unification and integration of their economies; and subjects which were previously regarded of local importance began to assume a national importance. The last two global wars necessitating the total mobilisation of the national resources led to the use of the apparatus of public finance by the federal governments for the sake of national mobilisation. The revolution in economic theory and practice brought about by the "Keynesian Revolution" tended to impart a great importance to fiscal policy as an instrument of economic stabilisation. The formulation of the technique of social accounting during the Second World War gave a quantitative expression to the Keynesian general equilibrium system; and with the help of this technique it became possible, to a large extent, to quantify the basis of a compensatory fiscal policy. In the post-war period, increasing importance has begun to be laid on the potentiality of fiscal policy as an instrument of economic growth.

Apart from this, there has occurred a complete change in the philosophy of the state, from one based upon concept of

laissez-faire to one based upon that of welfare. Thus, the increasing importance of fiscal policy has been associated with the increasing centralisation of the apparatus of public finance in these federal countries.

The growth of fiscal centralisation in these federal countries is reflected in the shape of the predominant importance occupied by the federal government both in the sphere of public expenditure as well as taxation. (Tables 2.1 and 2.2)

Before the depression, the federal government in the U.S.A. was mainly concerned with the primary functions of government and the state and local governments with the secondary functions. Since the New Deal, the federal government has taken over more of the responsibility for the expanding social services. Thus, the federal government has come to participate in a large number of social and developmental functions like flood control and irrigation, multi-purpose projects like the agricultural aid and research and financing of rural electrification. Though the process of economic growth in the U.S.A. has been left mainly in the hands of private enterprise, the federal government has been spending considerable sums of money through federal agencies such as the Research and Development Corporation on industrial research.

Similar trends towards the growth of the public sector and the relative importance of the federal government in it are also noticeable in Canada and Australia. As a result of the depression, the State governments in Canada failed to meet the responsibilities for the payment of the fixed charges on their outstanding debt and the cost of unemployment relief and other social services. In accordance with the recommendations of the Royal Commission on Dominion-Provincial Relations the Dominion government undertook the responsibility for unemployment insurance and direct administration and financial responsibility of assistance to farmers. It also assumed responsibility for the payment of the provincial debts. The Australian federal government has also played an increasingly important part in the financing of unemployment relief, provision of roads and encouragement of agriculture as well as in post-war reconstruction schemes.

There has also occurred profound change in the tax structures of these countries with the growing predominance of the

federal governments in them.

TABLE 2.1

Percentage Distribution of Government Expenditure in the U S.A.*

Year	*Federal*	*State*	*Local*	*Total*	*Total as % of the National Income*
1890	35.6	9.9	54.5	100	7
1929	27.0	17.6	55.4	100	12
1936	52.7	14.8	32.5	100	23
1940	48.5	20.1	31.4	100	22
1944	92.1	3.5	4.4	100	56
1948	67.5	15.7	16.8	100	N.A.
1953	74.0	13.0	13.0	100	34
1969	55.0	21.0	24.0	100	—
1972	51.0	24.5	24.5	100	—

*Estimated on the basis of figures contained in the *Statistical Abstract of the U.S.A.* and *Statistical Yearbook*, 1973, I.M.F.

TABLE 2.2

Percentage Distribution of Government Expenditure in Australia*

Year	*Federal*	*State*	*Total*
1938-39	40.5	59.5	100
1952-53	70.2	29.8	100
1973	56.0	44.0	100

*Yearbook of the Commonwealth of Australia, No. 40, 1954 and Bulletin No. 44, Commonwealth Bureau of Census and Statistics, Australia 1953-54, and *Statistical Yearbook*, 1973, I.M.F.

In Canada in 1950-51; the expenditure by the Dominion governments constituted 65 per cent of the total expenditure of the federal, state and local governments while the expenditure of the state and local bodies constituted 19 per cent and 16 per cent respectively of the total in that year. Estimated on the basis of figures in Canada Yearbook 1955, Dominion Bureau of Statistics.

Though the American system of public finance is still characterised by the existence of competitive and overlapping taxation of personal and business incomes, the hold of the federal government on these taxes has considerably increased in recent times. In 1931 the federal government derived 80 per cent of the aggregate proceeds of taxes on personal income,

TABLE 2.3

Tax Revenues of the Public Authorities in U S.A.*

(Amount in billions of dollars)

Year	*Federal*	*State*	*Local*	*Total*	*Total as % of the National Income*
1890	0.4	0.1	0.4	0.9	7.2
1920	5.7	0.6	2.8	9.2	12.5
1930	3.5	1.8	5 0	10.3	12.7
1936	3.8	2.4	4.3	10.5	17.0
1940	5.8	5.1	4.7	15.6	20.3
1944	41.2	5.4	4.8	52.4	29.9
1953	70.2	11.9	10.5	92.6	32.2
1972	295.8	110.0	105.0	510.0	40.0[1]

**Statistical Abstract of the U.S.A.*

1. As per cent of the gross domestic product. Figures refer to total revenues.

TABLE 2.4

Tax Revenues of the Public Authorities in Australia*

(Amount in millions (Australian)

Year	*Federal*	*States*	*Total*
1938-39	74.1	50.5	124.6
1952-53	895.4	71.0	965.4
1973	9081.0	6645.0	15726.0

*Yearbook of the Commonwealth of Australia, No. 40, 1954 and Bulletin No. 44 Commonwealth Bureau of Census and Statistics, Australia, 1953-54 and I.M.F. Statistical Yearbook Figures for 1973 also include those of the local Government.

In 1950-51, taxation by the federal government of Canada, amounted to 74 per cent of the aggregate tax revenues of the federal, state and local governments, while the state and local taxes constituted 14 and 12 per cent respectively of the aggregate tax revenues in that year. Estimated from *Canada Yearbook 1955*, Dominion Bureau of Statistics. The predominance of the Federal Government in Canada in this regard persists still.

profits, gift and inheritance, in 1953 the proportion rose to 96 per cent. The Dominion Government of Canada assumed completely the power of taxation of income and inheritance since

1943; and the provinces have been completely excluded from this field. In Australia also, the Commonwealth Government assumed complete control over income and inheritance taxes since 1943; and the provinces have been completely excluded from this field. In Australia also, the Commonwealth Government assumed complete control, over income and entertainment taxes since the war; and the states have been excluded from this sphere. This means that the direct-indirect dichotomy which, to a great extent, characterised the federal fiscal systems has been practically given up; and the federal government has acquired virtual monopoly over taxes on incomes and profits.

Thus, the federal governments have acquired an effective control for manipulating the apparatus of public finance. The growth of fiscal centralisation has also been considerably strengthened by the growing importance of federal grants in the finances of the regional governments.[14] The apparatus of federal grants in the U.S.A. has been used to counteract the perverse fiscal behaviour of the regional governments and to make them fall in line with the fiscal policy of the federal government. Thus, federal grants have become an important instrument in counter-cyclical policy.[15] It has been maintained that "by its policy of grants, Washington has conquered the 48 states and turned them into a superior kind of countries."[16]

In the beginning of the depression in the U.S.A., the perverse policy of the regional governments tended to weaken the efficacy of the federal counter-cyclical policy. As a result, the federal government had to counteract this tendency by encouraging them to undertake public works planning through their state and local planning boards but financed largely by means of federal funds. The grant programme was set in motion also because the fiscal ability of many state and local governments seemed to be seriously impaired by the effects of the depression.

The growth of fiscal centralisation has also been strengthened by the establishment of effective administrative machinery for co-operation and for co-ordination of fiscal policy of the public authorities in these federal structures. In the case of Australia, it has been possible to plan and execute a successful counter-cyclical policy because of the Australian Loan Council which has the authority to approve the schemes put forward

by different governments and also to arrange for the necessary finance. It has been maintained that the establishment of the Loan Council in Australia, "an institution for compulsory co-operation betweeen general and regional governments superimposed upon the federal system, is a unique event in the history of the financial relations of general and regional governments in a federation."[17] The growth of the fiscal centralisation and the institution for effective co-ordination of fiscal policy have turned "Australian federal constitution and government into a quasi-federal constitution and government."[18]

In the post-war years, the federal governments of U.S.A., Canada and Australia assumed the responsibility for maintaining the condition of high and stable level of employment. In pursuance of this policy, the U.S.A. Congress passed the Employment Act of 1946. The Act provided for the setting up of the administrative machinery required for the successful implementation of this policy. The Act enjoins upon the federal government "to use all practicable means consistent with its needs and obligations and other essential considerations of national policy, with the assistance and co-operation of industry, agriculture, labour and state and local governments, to co-ordinate and utilise all its plans, functions and resources for the purpose of creating and maintaining, in a manner calculated to foster and promote free competitive enterprise and the general welfare, conditions under which there will be afforded useful employment opportunities, including self-employment, for those able, willing and seeking to work, and to promote maximum employment, production and purchasing power."[19]

The Act has provided for the gathering together into one place the best information available regarding what is happening in the economy; and provision has also been made for the interpretation of these data, and for making the interpretation available to the President and Congress for action.

The President in his Economic Report presents a comprehensive picture of the nation's economic budget. In it, he analyses the state of the economy and the fiscal policy that the government has been following, and sets forth in it an integrated programme for promoting national prosperity in the year ahead in the light of the interpretation of the possible future trend of the economy. In the preparation of the Report, the President has

the services of all Government Departments, the advice of representatives of industry, agriculture, labour and state and local governments as well as of the Council of Economic Advisers.

Thus, the growth of fiscal centralisation along with the development of effective co-operation and co-ordination has tended to impart a large measure of effectiveness to fiscal policy as an instrument both of economic development and stabilization in these federal countries. Federalism developed by the Soviet Union is the constitutional expression of the multinational state. But political, social and economic direction is quite clearly at the centre; and centralised state planning is the original and distinctive characteristic of the Soviet Economic System. In accordance with Article 14 of the constitution of 1936, the powers of the All-Union authorities include the confirmation of the unified state budget of the U.S.S.R. as well as of the taxes and revenues which go to form the All-Union, the Republic and local budgets.[20] The national budget plays the part of the central agency where the income of the country is concentrated and through which it is redistributed to finance the planned objectives for the expansion of the country's productive capacity.

Federalism in a Developing Economy

The crux of the problem of economic development in an under-developed country lies in a significant expansion of the rate of its capital investment so that it attains a rate of growth of output which exceeds the rate of growth of population by a significant margin. Only in the context of such a rate of capital investment will a developing country begin to improve its standard of living.

In an underdeveloped country, there is a circular constellation of forces tending to act and react upon one another in such a way as to keep a poor country in a stable state of under-development equilibrium. The condition of under-development equilibrium is caused by a circular relationship existing on both the demand and the supply side of the problem of capital formation. "On the supply side, there is the small capacity to save, resulting from the low level of real income. The low real

income is a reflection of low productivity which in its turn is due largely to the lack of capital. The lack of capital is a result of the small capacity to save, and so the circle is complete. On the demand side, the inducement to invest may be low because of the small buying power of the people, which is due to their small real income, which again is due to low productivity. The low level of productivity, however is a result of the small amount of capital used in production, which in its turn may be caused at least partly by the small inducement to invest."[21]

Therefore, the low level of capital formation in an underdeveloped country is due both to the weakness of the inducement to invest as well as to the low propensity and capacity to save.

In such an economy, the low level of per capita productivity limits the magnitude of real demand for output, which as a result of the working of the acceleration effect tends to react unfavourable on the marginal efficiency of capital leading to the weakening of inducement to invest. The low inducement to invest also arises as a result of the deficiency of dynamic entrepreneurship which was regarded by Schumpeter as the focal point in the process of capitalist development.

Therefore "we are here in the classical world of Say's law. In under-developed areas, there is generally no 'deflationary gap" through excessive savings. Production creates its own demand, and the size of the market depends on the volume of production. In the last analysis, the market can be enlarged only through an all-round increase in productivity. Capacity to buy means capacity to produce."[22]

A high rate of investment and growth of output cannot be attained in an underdeveloped country simply as a result of the functioning of the market forces. Even the operation of these forces is hindered by the existence of economic regidities and structural disequilibrium. Economic progress is not a spontaneous or automatic affair. On the contrary, it is evident that there are automatic forces within the system tending to keep it moored to a given level.[23]

The vicious circle of underdevelopment equilibrium can be broken only by a comprehensive governmental planning of the process of economic development. A programme of planned and balanced growth including investment in different branches

of production alone can succeed in overcoming the hump that hinders the process of growth, whereas a single individual project might appear to be too unattractive. As Ragnar Nurkse puts it, "the main point is to recognise how a frontal attack of this sort—a wave of capital investments in a number of different industries can economically succeed while any substantial application of capital by an individual entrepreneur in any particular industry may be blocked or discouraged by the limitations of the pre-existing market. Where any single enterprise might appear quite inauspicious and impracticable, a wide range of projects in different industries may succeed because they will all support each other .... In this way the market difficulty, and the drag it imposes on individual incentives to invest is removed or at any rate alleviated by means of a dynamic expansion of the market through investment carried out in a number of different industries.[24]

Dr. Myrdal has pointed out that contrary to what orthodox economic theory would lead one to expect, economic inequalities between nations are increasing, and he has argued that this is bound to happen whenever the free play of market forces is allowed to continue unchecked.[25] He has maintained that the false assumptions of the classical economic theory have led it astray and its teachings and conclusions have proved definitely misleading to the underdeveloped countries. The classical economic theory believes in equilibrating tendencies in economic affairs; but the functioning of the market forces does not lead to a high rate of economic development in the underdeveloped countries. Therefore, Dr. Myrdal has argued that such a theory should be superseded by theories based on the principle of cumulative causation. If a backward community does not wish to remain caught in a vicious circle, it must interfere deliberately with the market forces in order to break it.

Arguing for governmental planning, Dr. Myrdal has maintained that "if an underdeveloped country really succeeds in starting and sustaining by its policy interferences, upward cumulative process of economic development, this will provide more and not less space for want of private enterprise such a country possesses or is able to foster. And the central planning will constantly have to aim at breaking the rigidities which are mark of underdevelopment, and to seek to establish greater

flexibility in the entire economic and social fabric."[26] Dr. Myrdal maintains that governmental planning represents "an attempt at a complete reversal of what once happened in the new developed countries as described by the Schumpeterian model."[27] The national plan cannot rationally be made in terms of the costs and profits of individual enterprises because most of the investments to be planned are not profitable from the market point of view. This is true not only of the big investments where the main purpose is to create the external economies for industries which are not yet in existence but are planned for a distant future.[28] The whole meaning of a national plan is to give investment such protection from the market forces will permit it to be undertaken in spite of the fact that it would not be remunerative according to private business calculations A national plan senses the inadequacy of private business calculations in terms of costs and profits as they do not reflect faithfully the social goals of national planning.

In the initial phase, the process of development in an underdeveloped country is hindered primarily owing to the lack of the basic economic foundation in the shape of the deficiency of environmental facilities and equipment. Their growth demands considerable investments in social and economic overheads. Such investments will lead to the creation of external economies which in their turn will provide incentives to the development of private enterprise in the field of industry as well as of agriculture.

Investments in social overheads will not be able to attract private enterprise, because the returns from them may not be realised in monetary terms, and the indirect returns from them in the form of an increase in the supply of technical skill and higher standards of education and health can be realised only over a long period. It may not be possible to divide such services into small units which can be sold at a price in the markets and such services being aggregative in nature yield an aggregative satisfaction. Besides, the provision of such services on the basis of the principle followed in the private sector of the economy will tend to violate the canon of equity which constitutes one of the cardinal doctrines of modern fiscal theory. Therefore, the criterion of social productivity as distinguished from that of private profitability is applicable in the case of investments in social

overheads, and this determines the direct participation of the government in the projects of this nature in the process of planned development.

The investments in economic overheads demand huge expenditures of capital which are usually beyond the capacity of private enterprise in an underdeveloped country. Besides, the returns from such investments can be realised only in the long run for which private enterprise is usually not prepared to wait. Therefore, the government alone can undertake such investments.

Thus, in the initial phase of the process of development the government of an underdeveloped country is required to create the basic economic foundation for development by direct public investments in social and economic overheads. The role of government which is relevant to economic growth has centred generally on nine categories of functions such as "maintaining public services, influencing attitudes, shaping economic institutions, influencing the use of resources, influencing the distribution of income, controlling the quantity of money, controlling fluctuations, ensuring full employment, and influencing the level of investment."[29] Though these functions have relevance for underdeveloped countries, the stepping up of the rate of development by forcing up the level of investment constitutes the principal function of government in an underdeveloped country.

The forcing up of the level of investment necessitates a corresponding forcing up of the level of savings. In the absence of government intervention, the rate of domestic saving is determined principally by the ratio of profits to national income, but this ratio is very low in an underdeveloped country. Therefore, in such a country a higher rate of domestic saving can be achieved only by force exercised through the medium of taxation and inflation. Therefore, as Prof. W.A. Lewis puts it, the range of governmental functions is "even wider in the less developed economies. For example, in the less developed economies research depends to a great extent upon public than upon private funds; the government has to concern itself to a greater extent with attitudes, the price mechanism functions less adequately; more pioneering by government is necessary; saving is more of a problem; there is greater poverty to be alleviated."[30]

The principal objective of every national development plan is to embody a decision to increase the total amount of investment aimed at raising the productive powers of a country. Besides the plan must define the means by which this can be done. A plan, apart from determining the total target of investment, has also to define the targets for different sectors. Planning by its very nature involves an allocation of resources in terms of a scheme of priorities determined by the central planning authorities in the light of their assessment of the needs and the potentialities of the economy. As an underdeveloped country has an acute shortage of investible resources, its planning authorities have to take into consideration the important fact that allocation of resources embodied in the plan leads to the acceleration of the rate of economic growth to the greatest possible extent.

The two problems involved in planning, i.e., the fixation of the total investment target and the allocation of that investment between different projects are usually treated separately for analytical convenience. But in essence, they are inter-dependent in significant aspects. "If non-linear relationship (e.g., diminishing returns, diminishing marginal utility) are introduced, the absolute size of investment should affect its allocation. Similarly, if the propensity to consume of the owners of factors of production used in the investment varies with the type of investment, the total amount of investment possible, given the surplus of consumer goods, will depend upon its allocation."[31]

Economic development has to be viewed as an induced and controlled cumulative process and a national plan for development is a blueprint of this process. As Dr. Myrdal puts it, "A national plan should be a blueprint of a cumulative process of economic development in a country, as this process will evolve when started, sustained and controlled by certain induced exogenous changes in the social system, represented by purposeful state interferences as defined in the plan. This blueprint must, therefore, be built on a study of the circular causation running back and forth between all relevant factors in the social system of the country, 'Economic' as well as non-economic."[32]

A comprehensive plan of economic development has to be viewed basically in terms of the supply and demand for real

resources in order to ensure equilibrium in the process of growth. Therefore, planning must be done in physical and real terms; and it has to be conceived in terms of a dynamic equilibrium between the growth of planned investments and the level of planned savings, both considered in real terms. As Dr. Myrdal puts it, "A whole cumulative expansion process has to be blueprinted in terms of concrete investment projects and their effects; on the volume of production in various lines, on consumption, on the employment of workers and natural resources, on health, education and the productiveness of labour, and so on, in various sectors and in different years, with main attention focussed on the circular causal interaction between all the factors in the system."[33]

In order to ensure that the supply of real resources is consistent with their demand, the entire problem of the demand and supply of real resources must be viewed by the planning authorities in the context of a comprehensive budget of resources. Apart from this, budgeting would be necessary for each kind of resources such as manpower, skilled labour and foreign exchange in order to ensure balance in the process of growth. In order to achieve inter-sectoral balance, it would be necessary to ascertain the consistency of the programme of investment in each sector and in each industry. This would necessitate the application of the Leontief input-output analysis to each industry.

In visualising the rate of economic growth to be attained by the economy, the planning authorities would be constantly faced with the problem of a conflict between the needs for consumption and those for investment; and the way in which this conflict is resolved determines the speed which the economy will attain in the process of its development. Planning for an accelerated and speedy rate of economic growth would involve the ploughing back of an increasing proportion of the increment in aggregate output into investment. But the extent of compulsion which is possible to exercise will be basically a function of the character of the political and social system of the developing country.

The planning authorities would also be required to visualise the growing pattern of aggregate output in terms of the changing structure of demand in a growing economy. The income

elasticities for different commodities and services tend to be different at expanding levels of income. The elasticity of demand for agricultural output tends to be less than unity after a certain rate of growth in the level of output has been attained. The elasticity of demand for manufactures tends to be more than unity, and that for services greater than that for manufactures at expanding levels of real income.

The important role that the government has to play in accelerating the rate of economic growth of an underdeveloped country imparts a peculiar significance to the apparatus of public finance for mobilising an adequate volume of resources. Due to the shortage of voluntary savings, the government is compelled to resort to the device of forced savings through taxation and inflation. The use of taxation for the mobilisation of development finance in a developing economy may be considered in two aspects: (1) Static and (2) dynamic. In the static aspect, when the economy tends to stay at a stable level of underdevelopment equilibrium, taxation as an instrument of development finance should impinge on the consumption constituent of aggregate demand in such a way that the basic incentives of the economy are not unduly impaired. To the extent that taxation releases resources from non-functional consumption and unessential investments, its importance lies not so much in the reduction of overall effective demand, but rather in the reduction of demand for certain resources which are thereby set free and made available to the public sector. But in its dynamic aspect, as the aggregate output tends to expand due to the expansion of investment, tax policy must aim at preventing the increment in output from being consumed by deliberately ploughing back an increasing proportion of it into the pool of investible resources of the public sector.

A developing economy has to develop an optimum tax system with the objective of mobilising the maximum volume of resources. But such a tax system must be built up in the light of certain criteria. In fiscal economics, the criteria of tax policy are constituted in the light of the announcement and distribution effects of taxes.[34] But a developing economy has to pay less heed to the distribution effects because giving a greater importance to them may come in the way of the economic

progress of the country. The optimum tax structure of the developing country has to be evolved largely on the basis of the consideration of announcement effects. Therefore, tax policy in a developing country has to be geared effectively to the taxation of non-entrepreneurial incomes, providing at the same time adequate incentive to the private sector undertaking useful production and essential investment. This means that the impact of the tax structure should be felt mostly on the restriction of consumption and unproductive investment.

The increasing importance of the role of government in accelerating its rate of economic development imparts a great significance to the appropriateness of the structure of public finance in a developing country. The institutional implications of comprehensive governmental planning involved in the process of economic growth and the need to utilize the instruments of taxation and public borrowing for the sake of mobilising an adequate volume of development finance for the public sector lead to the conclusion that the developing country must possess a structure of public finance capable of fulfilling these tasks effectively. Thus, a highly unified structure of public finance may appear to be the most appropriate model of one suited to a developing country. Viewed from this point of view, a federal structure of public finance in which constitutionally independent fiscal systems operate within a national economy may not conform to the requirements of a fiscal policy suited to a developing economy, unless the fiscal policies of the Federal and the State Government are effectively co-ordinated.

The requirements of central planning in a developing economy necessitate that the Federal Government must have the adequate powers of central guidance, supervision and leadership embodied in the written constitution and that it must have the necessary authority to enforce compliance with central planning decisions on the part of the regional governments. There should be no overlapping and conflicting jurisdiction in the sphere of income and business taxation. But these conditions are bound to modify the federal structure of public finance beyond recognition and some will express doubt whether such a structure will remain federal at all. But the logic of accelerated and planned economic development is not compatible with the orthodox concept of federal finance.

In the context of democratic planning, a significant measure of regional decentralisation is vitally necessary. The concept of democratic planning necessarily assumes an approach to development policy involving a beautiful blending of central planning and direction of development policy, and a large measure of decentralisation as regards its actual execution and implementation. Even in the Soviet Union, there have been significant developments in recent years towards administrative decentralisation in the spheres of industrial and agricultural development, programming and execution and administration of plans.

A federal fiscal structure usually obtains in a country with continental geographical dimensions. In such a country with large regional variations in the distribution of resources, regional planning must play an important part in the development of national resources. Regional planning will be able to take into account the needs of the different regions as well as their potentialities; and plans for their development can be effectively formulated and executed only by the regional authorities. But regional planning must be fitted organically into the larger framework of national planning. The regional authorities alone can evoke a larger measure of popular co-operation which is of very great importance in democratic planning.

Thus, in the context of democratic planning, the role assigned to the central planning authorities in a federal structure appears to be to help the regional governments in the formulation and implementation of their development plans and to co-ordinate them with the central plan so as to evolve a national plan on the basis of an appraisal of the needs of the economy and the availability of resources.

The institutional needs of central planning accompanied by effective regional planning and decentralised implementation demand that there should be effective planning institutions both at the central and regional levels and there should be complete co-ordination between central and regional planning decisions and authorities. It should not be beyond human ingenuity to evolve such planning institutions in a federal system of a developing country so that the needs of central planning of development policy may be made compatible with a substantial measure of regional decentralisation; outright centralisation

would be no solution to the federal problem in a developing country.

The entire problem needs to be viewed from the point of view of the concept of optimum adopted in the theory of industrial economics. From the point of view of national planning, a national planning institution may conform to the concept of optimum, but from the point of view of regional development it departs from the criterion of optimum. Besides, as regards the actual implementation of some of the development projects, too much centralisation would be wasteful and inefficient. Therefore, the executing agency must have an optimum size which is smaller than the national planning agency. It is true that with regard to the execution of certain schemes which are of national importance and which cover more than one state, the executing agency must have an optimum size which embraces the whole country. These optima can be reconciled only if there is a federal structure of public finance with sufficient authority to the Central Government to undertake and enforce central planning decisions along with regional planning and executing agencies.

But apart from the problem of formulation and implementation of planning decisions, a number of other issues also arise in the context of a federal system of public finance. One such issue is the question of the financing of the plan and the sharing of the financial resources between the federal government and the constituent units. Generally in the context of financing a programme of planned development, an imbalance tends to arise between the financial resources and the need for such resources on the part of the federal government and the constituent units. While the federal government has a command over expanding and elastic resources and also has the power to create money, the financial resources of the constituent units are limited and not as elastic as these of the federal government. At the same time the responsibility of the constituent units to undertake programmes of development is disproportionately large in comparison to that of the federal government. The problem of financial disequilibrium has been one of the most baffling problems in the developing countries with a federal system of public finance.

This, therefore, requires that an appropriate system be

devised to solve the problem of financial disequilibrium in a dynamic framework. A number of devices have been adopted in many of the developing countries to resolve the problem. One device is the devolution of resources from the centre to the states in the form of grants and loans to finance specific schemes of development. Another device has been the sharing of specific tax resources among the centre and states and their allocation among states in terms of definite criteria. But whatever be the scheme of allocation devised in the different federal countries, the financial dependence of the state governments on the federal government has tended to increase strengthening the tendency to fiscal centralisation. This has created a sense of resentment in the state governments and they have found their fiscal autonomy progressively eroded in course of the process of planned development.

Another issue that has arisen in this regard is the question of the achievement of inter-regional balance in development. It was argued in the first chapter of this book that the redistributive ideals of public finance have to be subordinated to the objective of maximising the rate of economic growth in developing countries. This might be true in the initial stages of the planning process in the developing countries. But it is to be borne in mind that large disparities in the levels of development in the different regions of a country tend to generate forces which produce adverse effects on the growth of the economy. There takes place migration of human and other resources from the regions with low levels of growth to those with high levels of growth. The regions with high levels of growth generate conglomeration economics attracting resources and industries to them Such tendencies create depressed regions magnifying disparities in levels of development and thus defeating the objective of the programme of planned development. These will have serious political overtones also.

Therefore, in the developing countries with a federal system of public finance it is necessary to bring about a pattern of resource allocation in order to achieve a national minimum level in essential services and infrastructure. The ultimate objective, however, should be to achieve an inter-regional balance in economic development through operating a system of resource allocation which tends to fill in the gaps in the need

for resources and their availability in a dynamic framework.

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6. See Friedman, W., "Federal Constitutions and Social Planning", *The Political Quarterly*, Jan.-March, 1949. pp. 54-63.
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   Prof. Harold Laski had also maintained that "the federal form of state is unsuitable to the state of economic and social development that America has reached." Laski, H. J., "The Obsolescence of Federalism", *The New Republic*, May 3, 1939, pp. 367-369.
8. See Maxwell, J. A., *The Fiscal Impact of Federalism in U.S.A.*, 1946.
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10. *ibid.*, Preface, p. vii.
11. *ibid.*, p. 31.
12. Birch, A. H., Federalism, Finance and Social Legislation in Canada, Australia and the U.S.A., 1955, for a discussion of the importance of co-operative federalism especially in the sphere of social legislation.
    In U.S.A. a Commission had been appointed in 1954 to investigate into the question of inter-governmental relations and the report of this Commission emphasises the revolutionary changes that have come into the character of American federalism in recent times. The Commission has concluded that after a little tidying up inter-governmental relations should be left roughly as they are now with perhaps a new doctrine called "co-operative federalism" to make it all sound more proper. "Federalism Revisited", *The Economist*, July, 1955.
13. Wheare, K. C., *Federal Government* (2nd Edn.), 1951, p. 255.
14. The Australian States, on average, now derive about 60 per cent of their revenues from federal services, and for the Canadian provinces apart from Quebec the Figure is about 30 per cent. If their accounting systems allowed for the inclusion of specific grants in general revenues, the proportions would be still higher. In U.S.A. federal grants contribute about 20 per cent of the total state revenues compared with a pre-war figure of 12 per cent. See Birch, A.H., *Federalism Finance and Social Legislation in Canada, Australia and the*

U.S.A., 1955, pp. 288-289.

15. See Maxwell, J.A. *Federal Grants and the Business Cycle*, p. 18.
16. Kjeld Philip, *Inter-Governmental Fiscal Relations*, 1952, p. 55.
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3

PROBLEMS OF FEDERAL FINANCE IN INDIA

The Problem Relating to the Central Planning of Development Policy in India

The structure of public finance as embodied in the Government of India Act 1935 and readapted after Independence in 1947; and that embodied in the new Constitution of 1950 assigned substantial powers and functions relating to economic development to the states. The general framework of the delimitation of legislative, administrative and fiscal competences of the Union government and of the governments of the States as embodied in the Constitution of 1950 represents largely an adaptation of the federal structure contained in the Act of 1935. Therefore, a description of the division of powers relating to economic development contained in the new Constitution would help in assessing the nature of the problem relat ng to the planning and coordination of development policy in Federal India.

The pattern of the distribution of powers in the new Constitution as in the Act of 1935 is based upon three categories (*a*) Union, (*b*) State, and (*c*) Concurrent [1] The powers contained in the Union and State lists of subjects define the respective spheres of action of the Union and the State governments; but with regard to the concurrent jurisdiction, the Constitution guarantees the supremacy of the action of the Union government by providing that any State law relating to a concurrent subject would be construed as *ultra vires* to the extent of its repugnancy to the Union law.[2]

Subjects in the Union list relating to economic development -- atomic energy, and mineral resources necessary for its production, control and development of the system of railway

transport, national highways, shipping and navigation on national waterways, maritime shipping and navigation as well as air transport, control over international and inter-State trade and commerce, the system of insurance, stock exchanges and markets, power to control industries in the private sector declared by Parliament to be expedient in the public interest, the responsibility for the development of basic industries in the public sector, the regulation and development of oil fields and mineral oil resources, petroleum and petroleum products, regulation of mines and mineral development and regulation and development of inter-State rivers and river-valleys.

(b) Subjects in the State list relating to economic development—the regulation and development of local government, public health and sanitation, hospitals and dispensaries, education, means of communication such as roads, bridges, ferries and other means of communication not included in the Union list, agriculture, cattle wealth, water supplies, irrigation and canals, drainage and embankments, water storage, water power except inter State waterways and inter-State river-valley schemes, to define the rights in or over land, to control the system of land tenures and to undertake projects of land improvement and colonisation, to arrange for agricultural loans, the development of forests, fisheries, gas and gas works, trade and commerce within the State and control over such industries not included in the Union list.

But apart from the assignment of substantial powers and functions relating to economic development, the States have been endowed with considerable independent command over resources; and also over the manner in which the resources given to them may be developed and utilized. Thus, the structure of public finance appears to put a sharp limit to the central planning of development policy.

The mobilisation of resources of the economy for accelerating the tempo of economic development resembles the total mobilisation of resources under war time. The federal structure embodied in the Act of 1935 and readapted after Independence as well as that contained in the new Constitution endowed the Centre with emergency power as a result of which it could ensure the fulfilment of conditions and obligations by the States considered essential for a planned and co-ordinated

implementation of development policy in the public sector.[3] It was also laid down that the executive power of a state has to be exercised in such a manner as to ensure compliance with Central policy, and the Centre could give such directions to the States as found necessary for the purpose.[4]

Besides the new Constitution of 1950 has provided for the central planning and co-ordination of development policy by including "economic and social planning" in the concurrent list of subjects with regard to which both the Centre and States have to work in complete unison; the Centre having a constitutional guarantee of supremacy of action in the sphere.

Thus, by endowing the Centre with emergency powers and by embodying the subject of "social and economic planning" in the concurrent list of subjects, the Indian federal system appears to have envisaged the unified operation of the structure of public finance for implementing a policy of planned development in the public sector.

The Problem of the Mobilization of Resources for the Public Sector through Taxation

The Indian federal structure has avoided a clear-cut dichotomy in the distribution of financial resources between the Centre and the States, and by providing for a number of equilibrating revenue resources, it has sought to correlate the resources of the states to their expanding fiscal needs in the context of an accelerated process of economic development. The pattern of distribution of revenue resources has been based upon the following categories:[5]

(*a*) Exclusively federal taxes, i.e., taxes levied and collected by the Union and appropriated by it;

(*b*) Exclusively State taxes, i.e., taxes levied and collected by the States and appropriated by them;

(*c*) Duties levied by the Union but collected and appropriated by the States;

(*d*) Taxes levied and collected by the Union, but assigned to the States;

(*e*) Taxes levied and collected by the Union and distributed between the Union and the State.

In the first category are included (*a*) duties of customs

including export duties, (*b*) corporation tax, (*c*) taxes on capital value of assets exclusive of agricultural land, of individuals and companies and taxes on the capital of companies, (*d*) stamp duties on transactions in stock exchanges and futures markets, (e) rate of stamp duty in respect of bills of exchange, cheques, promissory notes, bills of lading, letters of credit, policies of insurance, transfer of shares, debentures, profits and receipts.

The second category includes the following: (*a*) land revenue, (*b*) taxes on agricultural income, (*c*) duties in respect of succession to agricultural land, (*d*) taxes on lands and buildings, (*e*) taxes on mineral rights subject to any limitation imposed by Parliament by law relating to mineral development, (*f*) duties of excise of the following goods manufactured or produced in the State and countervailing duties at the same or lower rates on similar goods manufactured or produced elsewhere in India —(*i*) alcoholic liquors for human consumption, (*ii*) opium, Indian hemp and other narcotic drugs and narcotics; but not including medicinal and toilet preparation containing alcohol or any substance mentioned above, (*g*) taxes on the entry of goods into a local area for consumption, use or sale therein, (*h*) taxes on the consumption or sale of electricity, (*i*) taxes on the sale or purchase of goods other than newspapers, (*j*) taxes on advertisements other than advertisements published in the newspapers, (*k*) taxes on goods and passengers carried by road or on inland waterways, (*l*) taxes on vehicles whether mechanically propelled or not, suitable for use on roads including tramcars, (*m*) taxes on animals and boats, (*n*) taxes on professions, trades, callings, and employments, (*o*) capitation tax, (*p*) taxes on luxuries including taxes on entertainments, amusements betting and gambling, (*q*) rates of stamp duty in respect of documents other than those specified in the provisions of the Union list with regard to rates of stamp duty, (*r*) fees in respect of any of the matters in the State list, but not including fees taken in any court.

The third category contains the following: (1) such stamp duties and such duties of excise on medicinal and toilet preparations as are mentioned in the Union list. This provision has been made for the sake of achieving uniformity: because these duties are on things which demand uniform fiscal treatment throughout the whole country.

The fourth category includes the following items: (*a*) duties in respect of succession to property other than agricultural land, (*b*) estate duty in respect of property other than agricultural land, (*c*) terminal taxes on passengers carried by railways, sea or air, (*d*) taxes on railway fares and freights, (*e*) taxes other than stamp duties on transactions in stock exchanges and futures markets and (*f*) taxes on the sale or purchase of newspapers and advertisements published therein.

The fifth category has the following items: (*i*) taxes on income other than agricultural income. But the Parliament can levy surcharges in this regard entirely for the purposes of the Union, (*ii*) Union duties of excise other than such duties of excise on medicinal and toilet preparations as are included in the Union list.

From the point of view of the mobilisation of resources for the development plan of the public sector, the division of the powers of taxation between the Centre and the states gives rise to a number of important problems. The states have been assigned very extensive powers of taxation;[6] and as a result, the financing of the development plan of the public sector is bound to depend, to a very significant extent, on the mobilisation of resources by the States through an effective utilisation of their powers of taxation.

The division of the powers of taxation between the Centre and the states has been designed in a manner so as to avoid the problem of diverse and uncoordinated taxation of corporate incomes. From the point of view of economic growth, its significance appears to lie in the fact that the Centre can mobilise resources for the public sector in a manner so as to be consistent with the provision for adequate incentives in the private industrial sector; and the states have no power to interfere in the tax policy of the Centre in this regard. There exists the problem of unco-ordinated taxation of agricultural incomes in so far as the power to tax agricultural incomes has been assigned to the states.

In the field of commodity taxation, the federal structure poses the problem of an effective co-ordination in the tax policies of the Central government and the governments of the States, so that, apart from the mobilisation of the maximum volume of resources for the public sector, the tax structure as a whole

conforms to the criterion of efficiency and to a rational pattern of growth.

There is hardly any problem of co-ordination in the field of direct taxation because in India, unlike some other federal systems, the State governments do not have the power to levy an income tax on non-agricultural incomes. They have the power however, to levy an income tax on agricultural incomes. Some of the States have already levied this tax on agricultural incomes, while in some the tax has not been levied so far. The Taxation Enquiry Commission, 1954 has recommended that the agricultural income tax should be levied by all states in order to mobilise a larger volume of development finance for the public sector. The Commission had also recommended that for the determination of the personal rate of the central income tax, agricultural income should be aggregated with non-agricultural income and for the determination of the personal rate of the State taxes on agricultural income, non agricultural income should be aggregated with agricultural income. This would achieve a complete co-ordination in the taxation of agricultural and non-agricultural incomes. The Commission has also recommended that the tax rate applied to non-agricultural incomes should be identical with that applied to agricultural incomes. Besides, close understanding between the taxing machinery of the Central and State governments would be required for the successful operation of their tax policies in this regard.

It is in the field of outlay taxes that there is the greatest need for understanding and co-ordination between the policies of the Central and the State governments. In the field of commodities which are also subject to taxation by the Centre in the form of Union excises. In this respect, co-ordination in the tax policies of the two governments is very necessary. It has been suggested that the sales taxes on such commodities should be replaced by Union excises levied by the Centre and their proceeds should be distributed among the States on a basis recommended by the Finance Commission. Sales tax on tobacco, sugar and mill-made textile has been replaced by Union excises and their proceeds are being distributed among the States in accordance with the recommendations of the Finance Commission. It has been found that the proceeds from Union excises have been greater in these respects than the corresponding

proceeds from sales taxes on these commodities. If the sales tax levied on commodities on which Union excises are also being levied be replaced by Union excises, there would be reduction in administrative costs; but will create a difficult problem as regards the distribution of the proceeds among the States. The Jha Committee on Indirect Taxation has also suggested the replacement of sales taxes by Union Excises.

Commodity taxes are levied for achieving certain objectives of economic policy apart from revenue cansiderations. They may be levied as instruments of functional finance in order to reduce the volume of consumption in the economy and so to contain an inflationary pressure. These taxes can be reduced in the times of deflationary gap to raise the volume of aggregate demand and so to raise the level of employment and output in the economy and to arrest a deflationary pressure. In order that tax policy as a whole may be successful in achieving these objectives, there should be complete co-ordination between the Central and State governments. Uncoordinated taxation in the sphere of commodity taxation may not be compatible with the criteria of neutrality and equity in the theory of taxation inasmuch as the incidence of commodity taxes levied by different states may be different and the effects of such taxes are bound to transcend the boundaries of a State; and to distort the allocation of resources and the structure of production and so to hinder the process of economic growth.

Since the beginning of the First Five Year Plan in April, 1951, the apparatus of public finance has acquired a new dimension in India. Since then, India has embarked on a programme of planned and accelerated economic development and the tax policy of the Central and State governments has been utilised as instruments of development finance for the mobilisation of resources for the public sector. This has tremendously increased the importance of tax policy in the national economy. As the tax policies of the Central and State governments have been geared to the objective of mobilising development finance, they have tended to affect each other. This has tended to create a number of problems in the developing economy of the country. Therefore, it is necessary that there should be developed an integrated and national approach to tax policy.

During the Five-Year Plans, both the Union government as

well as the governments of the states have depended largely on outlay taxes for raising resources to finance the plan outlays. The major portion of the resources has been raised by the Union government through dependence on union excises which have, therefore, proved to be the most elastic source of tax revenues in the Central sector. The State governments, on the other hand, have raised the major portion of their resources by resort to outlay taxes such as sales taxes and excises. Thus the result has been that the same tax base, i.e., consumption expenditure has been competitively exploited by both the layers of government in India producing adverse effects on the behaviour of prices, the flow of resources and the cost of industrial production. This is because not only the final products passing into the hands of the consumers have been subjected to outlay taxes but also raw materials and inputs, and there has been an unplanned growth of outlay taxation both in the Central and State sectors.

The growing importance of the commodity taxes in the developing economy of India has raised a number of problems, the solution of which is necessary for the effective, efficient as well as equitable operation of the instrument of taxation as an apparatus of economic development. In view of expected large magnitude of the Sixth Five-Year Plan, the commodity taxes are bound to occupy an important place for the mobilisation of an increased volume of resources and it is necessary that the problems raised by the commodity taxes in the fiscal armoury of the country be solved. It is necessary to collect data regarding the working of individual taxes with a view not only to assessing their financial results, but, even more, of evaluating their effectiveness in securing the objectives of fiscal policy other than those relating to purely revenue considerations.

The increases in the commodity taxes both in the Central and the State spheres have affected the volume of consumption and savings in the economy. Besides, they have also affected the allocation and the total level of investment and production in the private industrial sector of the national economy. Therefore, it is necessary that comprehensive data be collected in this regard so as to constitute a dependable guide for tax policy during the Sixth Five-Year Plan in the light of those criteria of tax policy which are suited to a developing economy. In a

developing economy, tax policy must aim at maximising the rate of economic growth. Therefore, it is necessary that along with the mobilisation of an adequate volume of resources for the public sector, it must not produce an adverse effect on production in the essential and productive private industrial sector of the national economy. The collection of the data relating to commodity taxes as mentioned before will also provide a basis for the co-ordination of tax policies of the Central and State governments in this sphere. Besides, it is also necessary to estimate the incidence of commodity taxes levied by the Central and the State governments on different income groups in the economy, though the estimate of incidence of a tax is a complicated problem.[7] The calculation of the incidence of taxes embodied in the Report of the Taxation Enquiry Commission is not only theoretically questionable but also of very small practical importance in view of the assumptions and qualifications made therein.

In view of the changing and expanding role of taxation in the developing economy of the country, close co-ordination is necessary between the tax policies of the Central and the State governments. Besides, there is also the large and expanding field of public enterprises where it will be most useful to pool together the individual experience of the different states and of the Central government.

The surplus from public enterprises has tended to acquire an increasing importance in the resources of the Union and the State governments and the resources mobilised through the surpluses from public enterprises are now quite significant. These surpluses are the results of the price policy and the efficiency in management of the public enterprises. For accelerating the rate of economic growth of the economy, it is necessary that public enterprises should yield a significant and expanding investible surplus. This can be achieved through an appropriate price policy to be followed by these enterprises as well as by achieving an efficiency in their management, the criterion of efficiency being the minimisation of the average cost of production.

Therefore, it is necessary that a complete co-ordination in price policy be achieved for the public sector as a whole. Lack of co-ordination in this regard will have serious effects on the

growth of the economy. Price disparities in the public sector would lead to the flow and movement of resources which would be incompatible with the criterion of optimum allocation for the economy as a whole. A state having a lower price for the output of its public undertakings would attract resources from other states, though such a movement of resources would not be warranted by a condition of optimum allocation.

Problems of Co-ordination in Fiscal Policy

But co-ordination is necessary not only in the field of taxation and price policy of public enterprises but also in the field of public expenditure. In the sphere of public expenditure of the State governments, there are two components of it; one is the plan expenditure and the other is non-plan expenditure. The plan expenditure is an integral part of the Five-Year Plan and it is examined and approved by the Planning Commission before the beginning of the financial year in the form of the annual plan of each State. Therefore with regard to the plan expenditure there exists an effective co-ordination in public expenditure policy. But in case of the non-plan expenditure, no co-ordination exists, and there has been an unplanned growth in non-plan expenditure of the State governments. The growth of non-plan expenditure has the potential to generate additional demand which exercises an upward pressure on prices. At the same time, it has an adverse effect on the growth of the economy.

The non-plan expenditure of the states is constituted by expenditure on administrative services, natural calamities and payments of interest charges on public debt. In some cases, it has been also found that State governments have been making development expenditures outside the plan indicating a lack of co-ordination in public expenditure policy.

In view of the wide range of matters in which "co-ordination of tax effort and tax policies is required, and the need for an organisation under whose auspices inquiries into special aspects of the tax problem with a view to co-ordination at various levels may be pursued", the Taxation Enquiry Commission recommended the establishment of an All-India Taxation Council representing the Central Government and all the States.

The main object of the Council was to secure co-ordination, to the extent necessary, of the tax policies, tax legislation and tax administration of the states, as between the states themselves and as between the Union and the States; and tax matters pertaining to the states was to include those with which their local bodies are concerned. The Taxation Enquiry Commission was of the view that any dispute between states as also matters under discussion between one or more states and the Union which it is considered advisable to refer to a larger forum may be brought before the Council. The Commission further recommended that the members of the Council should be the Union and States' Ministers in charge of Finance and Local Self-Government. There was to be provision at the same time for (*a*) expert assistance through committees, official and non-official and (*b*) continuous expert study of the problems involved. The Council was visualised to have a permanent secretariat in the form of a Tax Research Bureau attached to the Union Finance Ministry. The organisation was "to study the tax system as a whole and in its main constituents, central, state and local taxes; to keep under review the main development in foreign tax system; to serve also as co-ordinating agency for tax statistics and take steps to improve the statistics for purposes of fiscal analysis and research; to undertake from time to time special enquiries relating to the working of particular taxes or groups of taxes, the effects of direct taxation on savings and capital formation, the impact of certain taxes on particular industries, the overlap that may arise between Central and State commodity taxation etc., and generally to aid governments in the formulation of tax policies by providing factual material and technical advice."[8]

The All-India Taxation Council has not been established as yet. To some extent, the work of co-ordination is being performed by the Planning Commission and the National Development Council. If the All-India Taxation Council is not established, it is necessary that a separate department be set up in the Secretariat of the Planning Commission on the model of the Tax Research Bureau which can perform the function visualised for the Bureau by the Taxation Enquiry Commission.

Public Borrowing and Monetary Policy

The Central Government has the power to control the issue of currency, coinage and other legal tender money as well as the authority to manage the country's foreign exchange. The Reserve Bank of India, the central bank of the country which functions under the control of the Central Government can undertake a fully co-ordinated monetary policy suited to the conditions of economic development.

Under the Reserve Bank of India Act 1934, the general supervision and direction of the affairs and business of the Bank was entrusted to the Central Board of Directors; and the Governor-General-in-Council had the power to supersede the Board if it failed to carry out any of the obligations imposed on it by or under this Act. In 1948, the Reserve Bank of India was nationalised, and the central control over the management of the Reserve Bank was further reinforced. It was provided that "the Central government may from time to time give such directions to the Bank as it may after consultation with the Governor of the Bank consider necessary in the public interest."

Both the Union government and the governments of the States have the power to borrow upon the security of their Consolidated Funds within limits fixed by the Parliament and the legislatures of the States respectively. The Government of India has the power to extend loans to the States from its own resources, and it can give guarantees in respect of loans raised by any State from the market. A State is required to obtain the previous consent of the Government of India in raising a loan from the market, if there is still outstanding any part of a loan which has been made to the State by the Government of India or in respect of which a guarantee has been given by it. As the States are indebted to the Central Government to a very large extent, it has considerable control over their borrowing operations and the types of investment financed through State borrowing. Thus, the Central Governments can safeguard the credit structure of the country by preventing unsound borrowing on the part of the States.

Both the Union and the State governments float loans in the market through the Reserve Bank of India and the Reserve Bank has also the responsibility of managing the public debt of

the Union and the States. Thus, the Reserve Bank is able to co-ordinate their borrowings and public debt policies and to manipulate them in a way so as to contribute effectively to the objectives of monetary and fiscal policies of the Central government.

The State governments in India borrow both from the open market and from the Union Government. The borrowing from the market by State governments is largely to finance their plan outlay and this forms an integral part of the resource plan approved by the Planning Commission. It has been suggested that in place of the State governments borrowing from the market individually, it will be better in the interest of effective co-ordination if the Central Government itself raises loans from the market and allocates the funds to the individual states in terms of their needs. This may have a number of advantages. It will mean less cost in borrowing, and the resource potentials can be tapped most effectively. But against it has been argued that borrowing by states has its own advantages since they can tap the local resources better in this way.

But the loans borrowed by the State governments from the Central Government have constituted the major portion of their loan finance to finance the plan outlay. The States have complained that the loans given to them by the Centre have been at a higher rate than the market rate at which the Centre itself raises funds from the market. The burden of the public debt the States owe to the centre has been rising progressively involving an increasing payment of interest which has been eating up a large chunk of the resources of the states.

In case of Australia, a Loan Council has been in existence to co-ordinate the borrowing policies of the Commonwealth Government and the States. So far such an institution has not been established in India since it has been felt that the Reserve Bank and the Planning Commission are quite effective in co-ordinating the borrowing programmes of the states.

The complaints of the States have not only been that the Centre has been profiteering in passing on "soft" loans from agencies like the IDA for projects executed by them but also with regard to the right to borrow from the public and the extent to which the resources of the banking system are available to them. The States are restrained in raising loans from

the market and in the matter of overdrafts from the Reserve Bank, they operate under serious constraints. The development of a rational system in the sphere of borrowing policy, therefore, has become very necessary.

The Problem of Financial Equilibrium

The scheme of distribution of resources between the Union and the States as embodied in the constitution has created an imbalance between the fiscal resources and the needs of the State governments and the gap in resources has tended to widen with the successive Five-Year Plans. With the implementation of the programme of planned economic development, there has been an increasing demand for social and developmental services involving larger need for resources. The State governments have disproportionately large constitutional commitments to implement the programmes of social and economic development in relation to their fiscal capacity to raise resources to finance them. The Union Government, on the other hand, has been found to be endowed with such fiscal resources which have been highly expansive in terms of the growth of national-income such as revenues from corporation tax and Union excises. But the development commitments of the Union Government in terms of the constitutional provisions have been limited and as a result the need for resources to finance development outlay has been less in proportion to that by the State governments.

It has been already pointed out that in a federal system a financial disequilibrium in terms of resources falling short of needs tends to arise in the sphere of the State governments. Therefore, a scheme of financial adjustment has to be devised to deal with the problem of financial disequilibrium. In the case of India, financial disequilibrium in the State sector has arisen on two accounts: (*a*) the disequilibrium has arisen in terms of the growing demand for administrative services and the need for resources to finance them, and (*b*) the disequilibrium has arisen with regard to need for resources to finance the Five Year Plans and the amount of resources mobilised by the states from their own sources. During the Fifth Five-Year Plan the gap in the plan resources of the State governments as

a whole was estimated at Rs 5000 crores.

The constitution has provided three methods to bridge the gap in the resources of the states. Firstly, there is the system of sharing the proceeds of income tax other than corporation tax and Union excises between the Union and the states. Secondly, the states are entitled to the entire proceeds of estate duty, the tax on railway fares and additional excise duties levied in lieu of sales tax. These taxes are administered and collected by the Union government. Lastly, the constitution has provided a system of grants which may be either conditional or in aid of general revenues.

But a very peculiar framework not originally envisaged in the constitution has developed with regard to the allocation of resources from the Centre to the states. While the question of the distribution of the proceeds from shared taxes and taxes collected by the Centre but distributed entirely among states as well as grants-in-aid is decided by a Finance Commission appointed at the end of every five years by the President of the Republic as provided by the constitution, the allocation of resources to the states to fill up their gaps in plan resources is decided by the Planning Commission. The Planning Commission is not a constitutional body but a body created by a resolution of the Government of India. Thus, there has developed an uncoordinated scheme of transfer of central resources to the states creating a number of administrative and other problems. It has so happened that the allocation of resources to the states in terms of the recommendations of the Finance Commission has not coincided with the allocation of plan resources by the Planning Commission thus preventing the emergence of an integrated and rational plan of resource allocation which would achieve the accepted goals of national fiscal policy such as equalisation of fiscal capacity and performance of the states. The approach to the question must undergo a change. There should be a simultaneous and integrated assessment of the gaps in the plan and non-plan resources of the states and plans for resource transfers formulated to fill in these gaps.

But the various methods of correcting the financial disequilibrium in the states' fiscal structure have created a number of problems which have led to fierce controversy being raised

in this regard. The State governments have become increasingly dependent on central resources for financing their plan outlays much to their dislike. Therefore they have been pressing for the maintenance of their financial autonomy by recasting the structure of resource allocation as provided in the constitution and by allocating them more independent sources of revenues which they can exploit to meet their growing fiscal needs. The arguments advanced in favour of allocating more independent sources of revenues to the states are that as a result of it they will be able to implement their plans of development more efficiently and effectively and this would bring about a higher rate of growth of the economy. Secondly, the dependence of the states to finance their plan outlays has led to a separation between the responsibility to raise resources and to spend the same and this has the potential to lead to waste and inefficiency. If, on the other hand, the responsibility to raise resources and to spend them lies with the same governmental authority there will be a better planning in the use of resources, there would be a greater incentive to economy and efficiency in their use. This is particularly important in an economy like ours in which there is serious constraint on development in terms of the scarcity of resources.

Besides dependence on central resources has led to delays in the execution of development projects and in many cases it has involved interference in the day-to-day execution of the projects by the Centre especially with regard to conditional and matching transfers. This has not been to the liking of the State governments. Besides, the transfer of resources now taking place on such a large-scale from the Centre to the states was not envisaged in the constitution and therefore, it is argued that it violates its spirit. Further, the point has been made that it is not a very healthy practice for the State government to approach the Centre with a begging bowl for everything and that the states should have their own resources to finance their plan outlay to a large extent. It is also maintained by those arguing the point of view of the states that the tendency to fiscal centralization emerging in the Indian economy is not compatible with the working of the democratic system. To make the democratic system a working and vibrant system, a greater decentralisation of functions and financial resources would be

of vital importance.

The complaint of the states has been that the resources transferred to them from the Centre other than those transferred under the recommendations of the Finance Commission have been discretionary in nature. The transfers by the Planning Commission which have progressively increased, though made under the Gadgil formula, are also considered descretionary by the states because not only the State governments must get their plans approved by the Planning Commission but that the Planning Commission itself is a creation of the Centre. Its recommendations, therefore, are different from those of the Finance Commission which is a body created by the constitution whose recommendations are generally accepted by the Centre.

But the complaint of the States has been much greater with regard to another form of discretionary transfer of resources which flows directly from the Central government outside the discipline of both the Planning and Finance Commissions. The transfer of resources under the Gadgil formula are based on certain objective criteria. But the direct transfers are purely discretionary and their amount has steadily increased. During the First Plan such transfers amounted to 7.5 per cent of the total transfer of resources from the Centre to the states. This went up to 41 per cent during the Fourth Plan before coming down to 24 per cent in the Fifth Plan; the most important of these is the schematic transfers covering centrally assisted and centrally sponsored schemes. The amounts of such transfers have sometimes exceeded the amount transferred under the Gadgil formula. Moreover, by their very nature such transfers have benefited the 'better-off' states as compared to the poorer ones particularly when they have involved matching contributions.

The other forms of discretionary transfers are the special accommodation for clearing overdrafts from the Reserve Bank of India and sharing in the small savings which are given on the basis of origin of collection and so they are advantageous to the 'better-off' states. Assistance for calamities has been another form of discretionary transfer and this has been criticised by the States.

The Central government has argued that these transfers

have the virtue of flexibility but the states have maintained that this itself has been its vice.

It has also been held by the states that the resources transferred to the states from the Centre to finance their plan outlays has, to a large extent, represented the flow of resources created as a result of deficit financing by the Centre. Since these transfers have taken the form largely of loans, the Centre, it is argued, has been making a profit out of the entire process.

On the other hand, a number of arguments have been advanced against the greater devolution of independent sources of revenues to the State governments. It has been maintained that this will lead to a weakening of the authority of the Central government and this in its turn will have an adverse effect on the planning process and the rate of growth of the economy. It is also maintained in this regard that the Central government has all along made sufficient resources available to the State governments to finance their plan outlays and it has virtually underwritten the financial implementation of the state plans, and that there have been many instances in which the states have failed to spend the funds made available to them for financing specific schemes of development.

It has also been maintained that the tendency to fiscal centralisation has been operating not only in the Indian federal system but also in the other federal system such as Australia, Canada and USA. This is because the tax operations of the Central government in a federal system cover business enterprises and other economic activities which have their ramifications throughout the whole economy. The State governments cannot be given taxing power in the form of corporation tax and excises since this will lead to enormous administrative complications and competitive and overlapping taxations which would produce adverse effects on the growth of the economy.

The basic grievance of the states seems to be that the transfer of resources from the Centre to states to finance their plan outlay under the recommendations of the Planning Commission has been largely in the form of loans involving growing debt burden on them. At the end of March 1978 the State governments owed the Centre over Rs 11800 crores as against a bare Rs 196 crores in 1950-51. During 1971-72 the loan instalment and interest due from eight states exceeded the loan transfers

from the Centre that year. The states have been pressing for a share in the corporation tax and a larger share in Union excises. But if the states are to be assigned a share in the corporation tax the constitution will have to be amended. So if, instead of the transfer of resources from the Centre to the states now taking largely in the form of loans and discretionary transfers, the transfers were to take place in terms of a greater share in tax revenues, much of the grievances of the states on this account can be redressed. But even when the states are given a larger share in central taxes, the role of grants as a factor to even out the gaps in uneveness cannot be ruled out.

Thus in the Indian federal system, a rational and scientific system of inter-governmental resource transfers has not evolved so far. A rational system of inter-governmental transfers of resources in the federal system must take into account a number of objective criteria: (*a*) the transfers should not be discretionary which involve political overtones but should be based on objective criteria of fiscal capacity and needs of the different states, (*b*) such transfer should be made under the recommendations of a statutory body like the Finance Commission which should make a thorough and integrated assessment of the needs of the states for financing both their plan and non plan outlays, (*c*) instead of the resource transfers for financing the plan outlays taking the form largely of loans as is the present case under the recommendations of the Planning Commission, the transfers should be made largely in terms of greater share in tax resources, (*d*) and the scheme of resource transfers must be related to the achievement of the objective of the national economic plan such as the achievement of inter-regional balance in development and raising the levels of development of the backward regions of the country. The resource transfers, therefore, should be based on objective criteria thus correcting the grievances arising from the discretionary nature of much of the resource transfers taking place at present. A committee appointed by the National Development Council at its meeting held in March 1978 went into the entire question of resource transfers to the states from the Centre in the light of the financial resources required to finance the Sixth Plan and to evolve a satisfactory solution of the problem.

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4

THE PLANNING AND COORDINATION OF DEVELOPMENT POLICY IN INDIA

India has initiated a process of planned development in order to utilise her resource potentials for raising the standard of living of the Indian people. The public sector has been playing an increasingly important role in this process of planned development. But the planning and implementation of the development policy have been carried out in the context of a federal structure of public finance in which the Central government and the governments of the states have their assigned spheres of action.

Thus, there has arisen the need for the creation of the necessary machinery and institution to plan and coordinate the execution of development policy in the Indian economy.

The Machinery of Central Planning and Coordination

Under the Post-War Development Planning

During the period of the War, the idea of governmental planning of the process of economic development in India gained a great popularity, mainly because the intense and growing war demand for material and talent revealed the potentialities as well as the weakness in the country's economy. The Central government took considerable initiative for the formulation of an integrated plan of economic development for the entire economy to be implemented in the post-War period; and to assist in the formulation of such a plan, it set up a Planning and Development Department in the year 1944. As a result of an examination and study of the various problems relating to post-War development through a number of committees appointed by the Centre, a common approach to the problem of post-War planning both by the Central and the

State governments was embodied in the form of two reports on 'Reconstruction Planning' issued in the course of 1944.[1]

Under the post-War development planning, the Coordination Committee of the Central Cabinet was in charge of the scrutinising and coordination of the development plans of the states as well as those of the Central departments. It had also the function to make recommendations to the Central government as regards the allocation of Central funds for development purposes. Besides, it was to formulate plans for the development of major industries and important minerals, and to determine the forms of state aid and state control to be extended to industries. In its work of the coordination of the development plans of the Central and State governments, the Committee was assisted by the Development Board.

But there did not exist a specialised and full-time organisation which could take a comprehensive and continuous view of planning as a whole. The Coordination Committee of the Cabinet was constituted by the Ministers of the Government of India who were preoccupied with the work of their own departments, and thus, they could not give their undivided attention to the planning and coordination of development policy at all levels and in all their aspects.

The Development Board had to carry out for the Central Cabinet a general examination of development plans. It had to examine and recommend priorities among development plans and schemes, and to keep a watch on development plans generally, and to make reports on the progress of development schemes. It had also to carry out for the Central Cabinet a detailed examination of memoranda on matters of general policy or administration affecting development as a whole, which were submitted to it by the appropriate ministries, and it could initiate action of any matter affecting planning and development policy generally.

But the Development Board could not perform these functions effectively. It was constituted by the departmental Secretaries of the Central government, who being engrossed with their own departmental duties, could not pay their continuous and undivided attention to the general problems of planning. Besides, it was "too large a body, too lacking in cohesion and too intermittent in its meetings to serve as an

instrument for keeping a continuous watch on planning activities and transmitting to subordinate authorities a constant flow of energetic pressure."[2]

The Development Board was later on abolished and its functions were taken over by the Economic and Statistical Coordination Section of the Cabinet Secretariat, established in 1949. The establishment of a wholetime section in a department of the Central government was a step in the right direction of achieving a better coordination in development policy. But by the time that the Economic and Statistical Coordination Section was established, the implementation of the development plan of the states was far advanced; and thus, it was too late for the basic defects in their development plans to be corrected. Besides, if the Economic and Statistical Coordination Section was to perform the functions entrusted to it effectively, the creation of a fully-equipped planning organ was necessary.

The Coordination Committee of the Central Cabinet was assisted by the Planning Branch of the Industries and Supplies Department as regards the formulation of plans for the development of major industries and important minerals. With regard to the development of foreign trade, it was assisted by the Commerce Department and the Tariff Board.

Thus, there did not exist a full-time and specialised institution which could take a comprehensive and continuous view of planning and development at all levels and in all aspects. The Advisory Planning Board, 1946, had recommended the establishment of a National Planning Commission "a single, compact, authoritative"[3] organisation, responsible directly to the Central Cabinet and devoting its attention continuously to the whole field of development. But such a Planning Commission was not appointed by the Central government until March 1950. Thus, there appears to have been an inadequate realisation of the institutional implications of effective central planning and coordination of development policy on the part of the Central government, in this period.

Since the First Five Year Plan (1951-52)

The establishment of the Planning Commission as a whole-

time and specialised institution, devoting its continuous and undivided attention to the problems of planning marked an important advance towards achieving an effective planning of development policy for the entire economy. At present it consists of nine members, five of whom are considered to be experts in the different aspects of the problems of planning, together with the Ministers of Finance, Home and Defence of the Government of India, and is presided over by the Prime Minister himself. In recent years there has been an expansion in the membership of the Planning Commission primarily as a result of the expansion in its functions and volume of work that it has to handle. In the beginning the Planning Commission consisted of six members but now its membership has gone up to nine. Previously, the Minister for Planning used to be its Deputy Chairman; but now one of the experts functions as its Deputy Chairman. The Prime Minister and the Minister of Planning are usually busy with their departmental duties and other important matters, and therefore, the appointment of an expert as its Deputy Chairman, who is not distracted by departmental functions and duties, is essentially a step in the right direction.

The structure of the Planning Commission is based upon the conception that the objective of comprehensive planning founded on a careful appraisal of resources, and on an objective analysis of all the relevant economic factors, can best be achieved by "an organisation free from the burden of the day-to-day administration, but in constant touch with the government at the highest policy level."[4] Thus the structure of the Planning Commission, as constituted at present, seeks to find out a compromise between the necessity of obtaining expert advice on matters relating to planning, and that of achieving a complete coordination in approach and outlook between the Planning Commission and the Central government. The similarity in approach and coordination in policy were further strengthened because of the fact that the Secretary of the Central Cabinet used to be also the Secretary of the Planning Commission, though the Planning Commission now has a wholetime secretary.

The Planning Commission has been given very comprehensive functions with regard to the various matters connected

with the problem of integrated national planning. In terms of the Resolution of the Government of India as issued in March 1950, the scope of its work was defined as follows:[5]

1. The Commission has to "make an assessment of the material, capital and human resources of the country, including technical personnel, and to investigate the possibilities of augmenting such of these resources as are found to be deficient in relation to the nation's requirements."[6]

2. It has also to formulate plans for the "most effective and balanced utilization of the country's resources"[7] and on a determination of priorities, it has to define the stages in which a plan should be carried out, and to propose the allocation of resources for the due completion of each stage of a plan.

3. The Commission has to make an analysis of the factors which tend to retard economic development and has to suggest the necessary conditions for the successful implementation of a plan.

4. It has also to make recommendations with regard to the establishment of the suitable machinery necessary for securing the successful implementation of each stage of a plan; in all its aspects; and to appraise from time to time the progress achieved in the execution of each stage of a plan; and to recommend the adjustments of policy and measures that such appraisal may show to be necessary.

Thus, the Planning Commission has to examine the suitability and the practicability of plans submitted by the State governments and the various departments of the Government of India; and to integrate them into an organic national plan by suggesting suitable adjustments in the light of the availability of resources and the overall needs of the economy.

The implementation of the planning decisions made by the Planning Commission is the responsibility of the Central and the State governments. The Planning Commission has stood out generally for the principle that it will not accept responsibility for the implementation of the plan. The powers of the Commission are purely advisory and recommendatory in character; and as such, it has no statutory authority to enforce the implementation of the planning decisions.

Though, in principle, the powers of the Planning Commission are entirely advisory, in practice, it has had to assume

duties wider than those of mere planning. For instance, it was entrusted with guiding the work of the Community Projects Administration. It has a range of other duties which have grown up in recent years, viz., watching the implementation of plans especially in the states through its team of Programme Administration Advisers, considering land reform programmes all over the country through a Central Committee for Land Reforms, and pursuing from time to time various policies and other questions independently with the central ministries and the states. Thus, for the strength of the personnel at its command the functions of the Commission have become more extensive than could be foreseen when it was established.

In terms both of the political and administrative assumptions in India, the role of Planning Commission as the instrument effecting coordination in the planning of development policy at all levels has been remarkably successful. In its work, the Planning Commission was favoured by several circumstances, such as the position of the Prime Minister, who is chairman of the Commission, the support given to the Commission's work on the political plane, the eminence and the place in public life of its individual members, the close links between the Planning Commission and the Finance Ministry at the Centre, the cooperation freely given and received at all levels, both at the Centre and the states, the objectivity and judgment which the Commission has shown in pressing its own ideas and in entertaining those of others.

In order to achieve an effective coordination in the implementation of Planning decisions within the larger framework of the plan as drawn up by the Planning Commission, and to prevent its independent modification either at the Central or the regional levels, a machinery of mutual consultation between the Central and the State governments and the Planning Commission has been established in the shape of the National Development Council. It comprises the members of the Central Cabinet, members of the Planning Commission and the Chief Ministers of the State governments with the Prime Minister as its Chairman. Its main function is to secure "complete coordination of policies, and timely concerted action,"[8] in order to obviate the danger of waste and misdirection of effort.

The meetings of the Development Council are held

practically every six months and even earlier in case of need, in order to review the progress of the plan, to approve adjustments and changes in planning policies, and in the structure of a plan itself, if considered necessary. But as the National Development Council is not a wholetime organisation, it appears to be an ineffective substitute for an organisation through which a continuous and informed exchange of ideas between the Centre and the states and between the states and the Planning Commission might have been possible.

The deficiency in the machinery of coordination has been sought to be made up by more frequent meetings of the National Development Council; and by the establishment of a Standing Committee of this Council. Besides, the holding of periodic conferences between the State Ministers and officials and their counterparts in the Central government have also contributed to a more effective coordination of development policy.

In the last meeting of the National Development Council held in March 1978 to approve the Draft Sixth Plan, a Standing Committee was appointed to consider the question of devising a rational scheme of allocation of resources to the states to finance their plan outlays.

During the period of the Five-Year Plans, a considerable proportion of the administrative and technical staff, both at the Centre and the states, concerned with planning, belonged to the All-India Services. They have been an important means for carrying a wide stock of talent to the states, and for preventing isolation between the thinking and experience of those who serve at the Centre and those who serve in the states. They have helped in avoiding differences in outlook between those who plan and those who execute, and this has been of the highest importance for progress on democratic lines.

Evaluation is an essential aid to the successful implementation of a policy of development, because it is important to assess how new policies and programmes are being received and what effects they have on questions relating to implementation of a plan of development at every stage. With the object of developing the techniques of evaluation, the Planning Commission set up in 1952 the Programme Evaluation Organisation as an independent unit for assessing the work of the National

Extension and Community Development Programme. In relation to this programme the task of the organising has been to keep all concerned appraised currently of the progress being made towards accomplishing the objectives of the programme; and to furnish an insight into the impact of the National Extension and Community Development Programme upon the rural economy and culture. Thus, the purpose of evaluation has been to assess whether the programme was succeeding in its fundamental objectives. The annual evaluation reports and the results of enquiries into particular aspects of the programme which have been prepared by the Programme Evaluation Organisation have assisted in the implementation of the Community Development and National Extension Programmes. Thus, through the development of the technique of evaluation and the necessary institutional apparatus for it, the Planning Commission has been coordinating and guiding the implementation of the Community Development Programmes in the states.

The Estimates Committee of Parliament had once suggested that the Prime Minister should not be the Chairman of the Planning Commission. The reasons underlying this suggestion were manifold. If the Planning Commission is completely free from all government influence and interference, it would formulate a plan in the light of its expert and realistic assessment of the availability of resources and the potentialities of the economy, completely free from all political considerations. As a result of the existence of the political elements in the Planning Commission, political considerations rather than considerations of sound economics are bound to preponderate in the deliberations of the Commission. The government in a democratic set-up has to win an election and it may give such pledges all of which it may not be able to fulfil. As a result, a plan dominated by political considerations rather than by the considerations of economics may be beyond the administrative and resource potentialities of the economy which, therefore, in its actual implementation, is bound to generate tremendous stresses and strains. This has been clearly and demonstrably evidenced in the course of the implementation of the Five-Year Plans.

There is no objection to a plan being of a huge dimension

if the nation has the will and the strength to undergo the sacrifice involved in the mobilisation of resources necessary for a plan of a large magnitude. But if a plan of a large size is formulated without keeping the factor of the availability of resources in view, it is bound to create disappointments if the plan is not implemented in its entirety apart from a number of economic problems which may inevitably arise.

There appears to be much logic and cogency in the contention that the Planning Commission should be an entirely expert body free from all political influences.

But a number of difficult problems may arise if the Planning Commission be made completely independent of the government. The Planning Commission is already being criticised as a super-governmental institution which is not responsible to Parliament, and this criticism will decidedly mount in volume if the Commission be made completely independent. If planning is to be effective and a development plan is to be effectively carried out, it is necessary that there should be a similarity of approach and unanimity of outlook between the government and the Planning Commission. Besides, it is for the Central and State governments to execute a development plan and the Planning Commission is exclusively concerned with the formulation of a development plan. Therefore, a complete coordination between the planning and executing agencies is vitally necessary. This is being effectively achieved as a result of the Prime Minister being the Chairman of Planning Commission and the Ministers of Finance, Home, Defence and of Planning, being its members. The approach to planning is bound to be deeply coloured by the political and economic ideology of the party in power in a democratic government. Therefore, the party in power can succeed in formulating a development plan according to its political and economic ideology only if the Planning Commission has an identical approach and outlook with the government of the day.

From an objective point of view, the composition of the Planning Commission should conform to two definite criteria. Firstly, it must possess sufficient technical expertise to approach the problem of planning in the context of an objective assessment of the essential conditions of effective and successful planning. Secondly, it must have an identity of outlook and

approach with the government of the day. These criteria are being fulfilled in spite of the present complexion of the composition of the Planning Commission. The members of the government who are on the Commission have no time to spare for the technical details of planning. Therefore, the government relies on the other members of the Commission for their technical knowledge and expert advice; and the detailed problems of planning have been practically left to them. The members of the government on the Planning Commission are mainly concerned with the broad problems of planning. Essentially the question is one of compromises and a beautiful blending of the criteria indicated above. The ultimate responsibility for executing a plan is that of the government and therefore it will necessarily see to it that its viewpoint prevails in the formulation of a plan. The criticism that the Planning Commission is a super-governmental institution is because every plan and all major planning decisions are approved by the National Development Council.

The Machinery of Planning at the State Level

(*a*) *Under the Post-war Development Planning*: Like the machinery of planning and coordination at the Central level, there did not exist an effective and competent machinery for a careful formulation and coordination of development plans at the state levels also. Some States did develop Coordination and Planning Departments, but even by 1950, such departments did not exist in some of them. Moreover, at regional and basic levels, Development Boards and Associations had been created in some of them, in order to achieve coordination in the planning and implementation of the development plan. But the entire machinery in the States, where such machinery actually existed, was "loose and poorly knit"[1] and as a result, the necessary coordination and unified control could not be achieved.

In fact, the approach to the problem of planning at the levels of the states was characterised by the spirit of departmentalism; and mutual consultation and exchange of information among the various departments of the State governments were not adequate for effective planning. As a result, the formulation and implementation of their development plans were

marked by a lack of realism.

(*b*) *Since the First Five Year Plan*: In the course of the First Five Year Plan, most of the states built up Planning departments, and they were placed in charge of whole time secretaries. The Planning Secretaries in many of the States were also given executive responsibilities as Development Commissioners in charge of National Extension and Community Projects. Inter-departmental coordination in planning matters was sought to be achieved by Committees of the Secretaries of various departments. Besides, over-all direction with regard to development planning was given by a Special Committee of the State Cabinet with the Chief Minister of the State as its Chairman. As the Chairman of the State Development Committee, the Chief Minister was able to bring about a coordinated and unified approach to the planning and implementation of the Community Development and National Extension Service projects which affect every one of the development departments in normal functioning.

Partly for lack of personnel, planning at the State levels had the aspects largely of inter-departmental coordination. As a result, the planning machinery at the State levels proved inadequate for the precise reporting and assessment of the progress of individual schemes. Besides, the statistical and economic staff in charge of the compilation of data in the states have not been working in close association with the Planning Departments.

The Second Five-Year Plan envisaged a fundamental change in the technique of planning. It visualised the fulfilment of development targets in the economy in the context of a long-term perspective, because there cannot be a complete balance between developments in each Five-Year Plan. As a result, the formulation and implementation of a development plan for a five-year period had to be geared to the long-range requirements of perspective planning.

A plan covering a period of five years was not regarded as "a once-for-all exercise"[10] in planning for that period. Continual watch had to be kept on the trends and developments in the economy, and in the light of a systematic observation of technical, economic and social data, the development programmes were to be adjusted on an annual basis. As a result, a

Five-Year Plan had to be broken up into annual plans, and on the basis of the performance and fulfilment of the annual plans formulated within the larger framework of the Five-Year Plan, programmes for development were to be adjusted on an annual basis.

As the Central and state governments operate in terms of an annual budget, they must be provided well in advance with the schemes of development readjusted on a consideration of the overall needs of the economy and the experience gained in respect of the fulfilmnet of the tasks set for the year about to end, in order to enable them to incorporate them into their annual budgets. It meant that the National Planning Commission must have the data for assessing the performance in the current year well in time for deciding in the light of this performance upon the programmes for the coming year and the appropriate fiscal and other measures needed to implement it.

But a federal structure by its very nature may involve some delay in getting the necessary data from all the governmental authorities. Therefore, an improvement in the planning organisation was considered vitally necessary, so that there might take place "a continuous flow of information and interchange of experiences, both upwards and downwards between planning agencies and executive organisations at all levels."[11]

In the context of the new technique of planning as visualised in the Second Five-Year Plan, the work of planning at the state levels was fundamentally changed. In the new context, planning at the state levels was concerned with the preparation of annual plans on the basis of an appraisal of the social and economic needs of the State; and of the performance during the past and current years; and the availability of financial and material resources. Besides, it had to undertake more precise reporting and assessment of the progress of individual schemes, in order to enable it to formulate the annual plans correctly.[12] Moreover, the annual plans, and the data of the social and economic needs of the State and of the progress of individual schemes were to be transmitted to the Planning Commission well in advance in order to enable it to formulate a comprehensive development programme for the whole economy for the next year in the light of the developments and the needs of the economy as a whole.

This meant that the planning machinery at the state levels must be able to function above the level and outlook of administrative departments; and it must possess considerable technical knowledge to fulfil effectively the tasks visualised for it under the Second Plan. But the planning machinery at the State levels, as it has existed under the First and Second Plans, both in its organisation and personnel, was not capable of fulfilling these tasks effectively. It had been concerned largely with the task of inter-departmental co-ordination of development activities; and it had functioned as a mere administrative department of a State government.

Therefore, for the effective fulfilment of the new tasks, a State Planning Board modelled on the lines of the Planning Commission was considered essential in each State so as to have an adequate command over technical knowledge required for planning and to secure an identity of outlook and views with the state governments and with the Planning Commission. In recent years, Planning Boards have been established in most of the states.

As there did not exist a specialised planning body at State level for a long period, planning at this level has been defective from a number of points of view. Due to the lack of a planning body, there did not exist an integrated and organic approach to planning; and there has been defective and inadequate co-ordination of plans and their implementation. Planning has virtually amounted to a collection of the plans of the different departments of the State governments. The result was that each department had been putting forward an over-zealous plan of development for the department which has no relationship with a realistic assessment of the available resources and the total plan which had been emerging for the State as a whole was beyond the resource potentials of the State. During the Five Year Plans, the States have been formulating very big plans which were not based on a realistic study of the resource potentials; and therefore, the result is that the Planning Commission has been slashing down drastically the size of the plans that the states have been putting forward. Such a process of planning does not conform to the criteria of effective planning of the process of economic development in an underdeveloped country.

Another serious defect in planning at the State level has been that global targets of investment have been allocated into different channels such as agriculture, industry, transport, power, etc., without working out the implications of such allocation and of the pattern of investment. Effective planning and the maintenance of inter-sectoral balance require that input-output ratios must be worked out for each industry. For example, agriculture will provide raw materials for industry and will demand the products of industry and the use of power. The growth of agriculture and industry will make an increasing demand on the transport system; and therefore, it is necessary to work out the inter-relationships between the different channels of investment. But these inter-relationships have not been worked out in connection with the pattern of investment and so it has not been based on any rational criteria.

Effective planning also requires that the level of proposed investment into each channel should be related to the planned growth of output in that channel; for which capital-output ratios need to be worked out. Though the estimate of capital-output ratios for future tends to become an exercise in the economics of probabilities and there is scope for a large margin of error, no such ratios have been worked out for the plans of the states; though such ratios have been worked out for the economy of the country as a whole, which have been a generalised description of the expected productivity of capital in each sector of the Indian economy and the expected ratios have diverged from the actual ratios. It is not necessary that the capital-output ratios of the State plans be the same as those for the country as a whole. They depend upon the composition of capital, the pattern of investment, the utilisation of productive capacity and the efficiency and effectiveness of the administrative machinery apart from a number of other factors.

Planning in a developing country requires that the allocation of resources should be worked out in terms of concrete schemes of development and a realistic estimate of their outlay and all the schemes for the different sectors should be viewed in the context of an integrated plan of development. Planning at the State level has not conformed to this criterion. The total planned outlay determined for the State as a whole has been allocated to each channel and this has been divided among the

districts without any rational criteria either of removing inter-regional disparities and the achievement of regional balance in development or in terms of concrete schemes of development for each district.

In development planning, allocation of outlay of investment without a detailed working out of concrete schemes would not only lead to wastefulness but would virtually amount to imposition from above. In a democratic scheme of planned economic development, the urge and the impulse for planned development must flow from below; there should be continuous flow and interchange of information and knowledge between the planning bodies at the base and regional levels, and the Planning Commission at the top, and schemes of development should be correlated to the regional and local needs and resources. In accordance with the recommendations of the Planning Commission, development committees consisting of officials and non-officials have been established in each district. Besides, the process of the establishment of village panchayats has made a great headway in all the states. But these are no substitutes for effective planning institutions at the regional and base levels, and therefore, there does not exist effective planning and co-ordinating machinery at the regional and base levels in each State which may transmit the urges and impulses from below to the planning body at the State level in terms of concrete and specific schemes of development.

The method followed so far for the formulation of the State plans should be abandoned and greater help and use should be made of planning bodies at the regional and base levels. These bodies should be asked to submit concrete schemes and their estimates in order of their priorities; the pattern of priorities having been determined by the Planning Commission. The schemes of the planning body at the base levels should be co-ordinated into a plan for the region by a regional planning body and arranged in order of their priorities as mentioned above. These regional plans should be co-ordinated into a plan for the State as a whole by the State planning body, and schemes should be arranged in order of their priorities; and then the State plan should be submitted to the Planning Commission for its approval. If his process is followed, it will become easier for the Planning Commission to

adjust the planned outlay for the State; and the adjustment of the outlay can take place in terms of rational criteria such as priorities of investment and concrete development schemes rather than in terms of a blanket adjustment of outlay without any rational criterion involved.

In formulating their plans, the regional planning institutions and the planning bodies at the base levels should keep in view the resources which can be made available at the regional and base levels. If the availability of resources is kept in mind, realism will be imported into the process of development planning.

The State planning body will formulate the plan for the entire State keeping in view the amount of the resources which can be raised for the financing of the plan. The State planning body should have some schemes in reserve the implementation of which would depend upon the extent of resources to be available from the Centre in the form of grants and loans. Thus the Planning Commission can adjust the total investment outlay in the State plans in terms of concrete schemes of development.

Though all the state governments have constituted Planning Boards, planning at the State level does not seem to have become an effective process. The State Planning Boards have the Chief Minister of the State as their Chairman with Ministers of Finance and Planning as their members and a senior officer as Deputy Chairman assisted by a few experts as members. But the expert elements in these Boards seem to be quite weak and the Planning Boards in their function and outlook are dominated by an official and bureaucratic approach. However, in some states the Planning Boards contain a larger expert element and in them the Planning of development process has been more effective. In spite of the constitution of the State Planning Boards, the basic defects in Planning at the State levels pointed out earlier, tend to persist. There is no integrated and organic approach to planning and the State Plans continue to be a collection of departmental plans, without an integrated assessment of the needs and resources.

In some states, however, perspective plans of development have been drawn up and exercises have been undertaken in resource mobilisation and steps have been taken to strengthen the statistical basis of planning process. The State Planning

machinery is also weak with regard to evaluation and monitoring functions. The Draft Sixth Plan has laid a greater emphasis on area development with a view to achieve an integrated rural development, with this end in view, it has emphasised the importance of block and district level planning but no organisations exist at these levels for the purpose. The Draft Sixth Plan has maintained that "It is now necessary that the district level planning, evaluation and monitoring cells with the necessary expertise are developed immediately so that detailed planning now contemplated can be effectively executed. It is also necessary to create smaller cells at the block level, the block being the primary area for local planning and these cells should be manned by specialist personnel with professional competence in local planning, monitoring and evaluation."[13]

The question, however, was examined by a committee appointed by the Planning Commission under the Chairmanship of Prof. M. L. Dantwala and the committee has recommended a selective approach to the question. It has recommended that planning at the block level may begin only in selected blocks and with the experience gained in course of time the process could be progressively extended to other blocks.

Thus, effective planning organisations have not developed at the State, and district levels so far. The development of effective planning, evaluation and monitoring organisations at the state, district and block levels is vitally necessary for the success of the planning process in the country.

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5

THE FISCAL STRUCTURE AND PROBLEMS OF DEVELOPMENT FINANCE

The process of planned economic development initiated in 1951-52 with the First Five Year Plan has involved on expanding role for the public sector in India. The programmes of development of the public sector in each five-year plan have been distributed into the Central sector and the States sector in terms of the criteria and decisions of the Planning Commission and the National Development Council. Since the development outlay in each five-year plan has been progressively stepped up, this has led to the need for raising an increasing volume of financial resources by the Central and State governments to implement the plan outlay. But this has brought into sharp focus the incompatibility between the distribution of the revenues resources and resource requirements of the development programmes of the Central and state governments. This has, therefore, revealed that the constitution had not envisaged the problem of enormous imbalance which may arise between the fiscal need and capacity of each layer of government in a developing economy. An analysis of the pattern of financing of the public sector outlay in each of the five year plans abundantly illustrates the sharp and growing differences in the responses of the resource structure assigned to each layer of government to the dynamics of development planning.

Since the resource structure of the States has not adequately responded to their growing needs for development finance, the gap has tended to be bridged largely through central resource transfers which has led to the increasing financial dependence of the States on the Centre and this has created enormous complications for inter-governmental financial relations.

The First Five Year Plan

During the First Five-Year Plan, the aggregate outlay on the Plan over the five years was about Rs. 1960 crores as against the original plan target of Rs. 2069 crores and the revised plan target of Rs. 2378 crores. The original plan target of outlay was raised and number of adjustments were made primarily to provide more employment opportunities.

The expenditure by the Centre is estimated to have been about Rs. 1115 crores and that by the states about Rs. 897 crores as against the original and the revised plan targets of Rs. 1234 crores and Rs. 1390 crores for the Centre and Rs. 835 crores and Rs. 988 crores for the States respectively. The tempo of development outlay in the beginning of the Plan was slow; but as the details of the development schemes were fully worked out and the administrative machinery became increasingly geared to the task of development planning, the tempo of the Plan was considerably accelerated. There was a substantial stepping up of development outlay in the fourth and fifth years and as much as 57 per cent of the total expenditure over the five-year period being accounted for by these two years. Therefore, the progress in raising resources and the pattern of financing that emerged were closely linked up with the phasing of the plan outlay.

As compared to the revised plan targets of development outlay, there took place shortfalls either because of the late commencement of the schemes or because of indequate administrative and organisational arrangements for implementation. In the case of the programmes of industrial development, the shortfall was due to the fact that the iron and steel and heavy electrical plants took much longer time than was expected. In case of Community Development Projects, the provision of Rs. 90 crores was only a rough estimate, and secondly the level of expenditure proposed per unit of development area was reduced later in the light of experience. The Planning Commission in its review of the First Five-Year Plan, May 1957, had not sufficiently emphasised the inadequacy of resources as one of the factors accounting for the shortfall in the realisation of the plan target of development outlay; but an analysis of the pattern of financing and the amount of domestic resources

mobilised by the governmental authorities go to show clearly that the inadequacy of resources was an important factor for the failure to realize the plan target of development expenditure.

Domestic Resources

In the Plan as it was originally formulated, the estimate of total domestic resources to be raised by way of taxes, loans, small savings, was put at Rs. 1258 crores; and the remaining amount of Rs. 811 crores was proposed to be financed partly from external assistance and partly from a combination of measures to raise domestic resources through taxes of loans or deficit financing as the conditions warranted. Though the target of development outlay was subsequently revised, the target of the volume of domestic resources to be raised by the government authorities was not correspondingly raised and this means that a larger resort to the method of inflationary finance had to be made to finance the increased outlay on development. The result was that the volume of budgetary resources raised through surplus in current revenues, small saving and market borrowing amounted to Rs. 1277 crores, a little over the original plan target of Rs. 1258 crores. External assistance utilised during the plan amounted to about Rs. 200 crores which was about Rs. 50 crores more than the assistance forthcoming when the Plan was formulated. Therefore, the extent of actual deficit financing exceeded the limit of Rs. 290 crores as indicated in the Plan. For the five-year period, the total amount of deficit financing has been placed at Rs. 420 crores.

Revenue Surplus

In the context of a federal structure of public finance, the resources have to be raised both by the Central and the state governments for financing the development outlay of the public sector. The extent of compatibility of federal finance with the criteria of a fiscal policy suited to developing economy depends in this regard upon the performance of the State governments in mobilising an adequate volume of resources required for their development plans.

Of the outlay of Rs. 1115 crores at the Centre over the five-year period, Rs. 420 crores or about 38 per cent of the total was financed from revenue surpluses and the earnings of railways; Rs. 358 crores or some 32 per cent became available by way of net receipts from loans, small savings and other capital receipts. As against this total of Rs. 778 crores, the Centre transferred Rs. 350 crores to the States by way of Central assistance for State plans. The balance of Rs. 428 crores remaining with the Centre was augmented by the receipt of Rs. 203 crores of funds from abroad. Thus the Centre has at its disposal a sum of Rs. 631 crores against its plan outlay of Rs. 115 crores. On this basis, deficit financing at the Centre for the five-year period work out at Rs. 484 crores. The account figures for 1955-56 show the actual deficit in that year at Rs. 180 crores which means that for the five-year period the deficit of the Centre was Rs. 428 crores.[1]

In the States, of the total outlay of Rs. 897 crores, Rs. 269 crores or about 30 per cent were mobilised from their current revenues, Rs. 230 crores or 26 per cent from public borrowings and capital receipts and Rs. 350 crores or 39 per cent represented the contribution of the Centre. There was still left a deficit of about 5 per cent on the basis of the revised estimates for the final year. Actually, however, taking the plan period as a whole there had been little deficit financing by the States together.[2]

In the Plan as initially formulated the contribution of current revenues including fresh taxation and the receipts of railways were estimated at Rs. 740 crores. Thus, the surpluses of public authorities were assumed to contribute 58 per cent. The contribution of current revenues and the earnings of railways over the plan period amounted to Rs. 690 crores as against the target of Rs. 740 crores. The shortfall was accounted for by lower contributions from the railways, the balance from revenues taking the Centre and the states together being close to expectations. The Centre was able to find from current revenues Rs. 145 crores more than the plan targets while in the States there was almost an equal shortfall. This shortfall in the states occurred in spite of the transfer of Rs. 80 crores to them under the recommendations of the first Finance Commission.

Thus, the performance of the Centre in the mobilisation of

resources from current revenue was quite satisfactory, whereas the record of the states was rather disappointing. As a result, from the point of view of the mobilisation of adequate resources, the federal finance in India has not been compatible with the criteria of a fiscal policy suited to a developing economy.

Resources from Additional Taxation

The Central Government imposed substantial taxation in 1951-52 partly for mobilising the maximum volume of resources but mainly for anti-inflationary purposes. Export duties which had been raised in 1950-51 were raised further on a number of commodities in order to siphon into the public exchequer a significant proportion of the increment in incomes resulting from an improvement in the terms of trade. The other measures taken in that year included a surcharge on income tax, an increase in the corporation tax, additional excise duties and import duties. Altogether, the increase in taxation proposed in that year amounted to Rs. 32 crores.[3] Towards the close of the year, it became necessary to reduce export duty on jute. In the two subsequent years, inflationary pressures had diminished and some further reductions had to be made in export duties in view of the world conditions and the demand for India's exports. The other changes made in these two years were relatively small. In 1954-55, significant increases were made again in excise duties. During the last two years of the Plan, the development outlay was considerably stepped up in order to realise the targets of development expenditure in the Plan. Consequently, there was the need for a larger volume of resources. During 1954-55, the Central Government resorted to additional taxation amounting to Rs. 11 crores. In 1955-56, both direct and indirect taxes were raised further; the important increases being under income tax and excise duties. The yield of the new tax measures was estimated at Rs. 17 crores for the year. It has been estimated that over the period of the First Five-Year Plan, the yield of additional measures of taxation at the Centre excluding export duties amounted to about Rs. 176 crores.

As regards the States, the contribution from revenues over the five-year period was Rs. 269 crores as compared with the

plan target of Rs. 410 crores, a shortfall of about 34 per cent despite the transfer of Rs. 80 crores to them as the result of the recommendations of the First Finance Commission. The target of additional taxation by the States as laid down in the Plan was Rs. 230 crores. But the actual yield of all the measures of additional taxation by the States over the plan period has been estimated at Rs. 80 crores. Thus, the "conclusion is inescapable that the progress in the matter of additional taxation in the States has not been commensurate with the requirements of the Plan.[4]

Of the total yield of Rs. 80 crores, about a half was accounted for by general sales tax, tax on the sale of motor spirit and sales tax on tobacco, cigarettes and cigars. Taxes on motor vehicles also made a significant contribution. Irrigation rates were put up in some States; but these increases yielded only Rs. 6 crores as compared to the plan estimate of Rs. 29.5 crores. The additional revenue from the taxation of land turned out to be only Rs. 5.4 crores as against the plan target of Rs. 34 crores. The States' share of Estate Duty amounted to only a little over Rs. 2 crores as against the plan target of Rs. 21 crores.[5]

Thus, to the extent that taxation in a developing economy has to be used as an effective instrument of development finance for the mobilisation of maximum volume of resources, the federal structure of public finance in India has not been compatible with the criterion of a tax policy suited to a developing economy.

Public Borrowing

The targets for public borrowing in the First Plan were kept low in view of the fact that when the Plan was formulated the market was weak and so the prospects for a large-scale borrowing programme were far from encouraging. Therefore, the targets for borrowing by the Centre and the states were fixed at Rs. 36 crores and Rs. 79 crores respectively. But the total net borrowing by the Centre and the states together during the plan period amounted to Rs. 205 crores. This means that the plan target of public borrowing was exceeded by Rs. 89 crores. Taking the Centre and the States together the net

borrowing was exceeded by Rs. 89 crores. Taking the Centre and the State together the net borrowing from the market in 1951-52 was negative to the extent of Rs. 22.8 crores. This means that Rs. 22.8 crores was paid out by way of repayment of maturing loans. In the next two years the market showed some improvement, but *it was not until the fourth year* that substantial borrowing programmes could be undertaken.

The Centre continued to make repayments for the first three years; Rs. 34.2 crores in 1951-52, Rs. 0.9 crore in 1952-53 and Rs. 37.2 crores in 1953-54. The States were able to put through moderate borrowing programmes in the first two years and were able to step them up substantially in 1953-54. In the first three years of the plan taking the Centre and the states together, repayments of maturing loans exceeded the contribution of the fresh loans by Rs. 5 crores.[6] In 1954-55, the Centre raised a combined loan of Rs. 159 crores of which Rs. 46 crores represented maturities, the net borrowing thus amounted to Rs. 113 crores. Of this, Rs. 26 crores was made available to the states. In addition two states were able to borrow Rs. 7 crores directly. In 1955-56, the net loan receipts of the Centre and the states combined amounted to Rs. 89.4 crores. The total net borrowing by the Centre over the plan period amounted to Rs. 49 crores as against the target of Rs. 36 crores and by the states Rs. 155.4 crores against the target of Rs. 79 crores. The aggregate borrowing by the states of funds from the market exceeded by a significant margin the plan target of borrowing. Thus, the fiscal behaviour of the States in this regard has more than conformed to the expectations of the Plan; and as a result, the federal structure of public finance has operated as a distinctly advantageous institution for the mobilisation of resources for the public sector.

A number of factors have combined to contribute to the success of the borrowing programme of the public authorities during the period of the Plan. A certain reorientation was given to the market borrowings; and planned development succeeded in establishing a direct and meaningful link between government borrowings and public investment; and fuller co-ordination was developed with the states in borrowing from the market. Besides, with the subsidence of inflationary conditions and the restoration of stability in money and capital markets, there

took place a revival of confidence especially since the beginning of the fourth year of the Plan. The significant growth in national income, and the larger dose of deficit financing during the two years of the Plan also contributed materially to the success of public borrowing.

The reorientation of the technique of borrowing during the plan has consisted not only in the linking up of government borrowing and public investment, but also in the bunching together of short, medium and longer term issues with a view to securing a better response from the different categories of investors whose requirements vary.

Besides, the net repayment of debt on Central Government account during the first three years of the Plan provided suitable liquid conditions in the market for the success of the State loans in that period. By its decision not to approach the market for funds in 1952-53 in the wake of the new monetary policy, the Central Government created a suitable climate in that year in the market for the success of State loans. Moreover, the timing of the floatation of the State loans was also adjusted in such a way that it was made to synchronise with the existence of slack season in the market when the institutional investors had spare funds to invest.

The yield on the securities of the state governments was made progressively more attractive as a result of a rise in their yield partly by raising the rate of interest on the State loans from 3 to 3.5 per cent and then to 4 per cent in response to the new monetary policy, and partly by shortening the period of their maturity.

The States also made energetic efforts to extend the popular attraction for loans by making an appeal to the small-scale investors in the rural areas. In 1953-54, the state of Madras approached the small-scale investors in the rural areas through the district officers for the purchase of the state government securities and about 60 per cent of the total loan subscription of Madras State in that year was made by the small-scale investors.

This has abundantly demonstrated the merit of the federal fiscal structure in tapping the small savings of the rural investors through the borrowing programmes of the States. These savings might remain largely untapped in a completely

centralised borrowing policy directed from New Delhi. Thus, a completely centralised borrowing policy might not prove appropriate for the mobilisation of maximum volume of resources for the public sector.

Small Savings

The total resources mobilised from small savings programmes amounted to Rs. 237.2 crores during the period of the Plan as against the plan target of Rs. 225 crores. Thus, the performance in this regard was quite satisfactory. The collections from small savings in the last year of the Plan were double the collections in 1950-51 and it is noteworthy that about 12 per cent of the plan expenditure was financed by the collections from small savings.

For the mobilisation of resources through small savings, the states have been functioning as the agents of the Central Government. A formula was devised in accordance with which the net proceeds from small savings were to be distributed between the Centre and the States. The formula was that each State got 25 per cent of the average net collection in the State for the three preceding years plus 50 per cent of the excess over this average. The amount distributed to the State in this way was to be treated as loan given to the State by the Centre. Such a formula was devised in order to give an incentive to the states for the mobilisation of an adequate volume of resources through small savings. This was found later to be not sufficient to induce the states to make the energetic effort and so it was changed under the Second Five Year Plan.

Conclusion

The tempo of development expenditure was considerably accelerated in the last two years of the Plan, but the mobilisation of domestic resources did not keep pace with the progress of development expenditure. As a result, a significant portion of development expenditure in the last two years of the plan was financed through inflationary finance, and over 60 per cent of the deficit financing in the plan period is accounted for by the last years of the Plan. Most of the surplus from current

revenues available for development financing was available during the first two years of the Plan in the context of the buoyancy imparted by the Korean boom when the plan outlay was rather on a low level. Thus, "it is exactly when plan expenditures rose substantially in the later stages of the Plan that increasing resort to deficit financing had to be undertaken. Deficit financing is safe and useful while there is a slack in the economy and production can be increased fairly quickly by utilising idle capacity or manpower. But, once the available production capacities are being more or less fully utilised, a further stepping up of investment expenditures through deficit financing cannot but generate inflationary pressures. In other words, the considerations that govern the feasibility of deficit financing are rather of short-term character and while they warrant an expansion or a contraction of a part of public expenditure in response to the needs of the situation, deficit financing cannot be relied on for a continuous increase in public outlays year by year except within narrow limits. Such increase can only be supported by expansion of normal budgetary receipts".[7] The significant amount of deficit financing undertaken in the last two years of the Plan led to a considerable build up of inflationary pressures which proved an intractable problem during the Second Plan.

The total public expenditure stood at Rs. 960 crores in 1950-51; whereas in 1955-56 (R.E.), it went up to Rs. 1687 crores. The total revenue receipts stood at Rs 780 crores, and total capital receipts amounted to Rs. 238 crores in 1950-51. This means that as against a total public expenditure of Rs. 860 crores, the total receipts amounted to Rs. 1018 crores. But in 1955-56 (R.E.), the total revenue receipts stood at Rs. 967 crores and capital receipts amounted to Rs. 427 crores. Thus as against the total public expenditure of Rs. 1687 crores, the total receipts amounted to Rs. 1394 crores. Thus, the growth in revenues did not keep pace with the growth in public expenditure; and the disequilibrium in this regard was partly accountable to the failure of the States in gearing their tax policy effectively to the objective of the mobilisation of an adequate amount of resources.

The total revenue receipts in 1955-56 were higher by 24 per cent than the revenue receipts in 1950-51. But the growth of

revenues was not continuous. There was a big spurt in revenues in 1951-52 and a quick decline to lower levels in the subsequent two years largely as a result of the collapse of the Korean boom. In 1954-55 the level of public revenues was about the same as in 1951-52 and it was only in the last year of the plan that the level of 1951-52 was substantially exceeded. This abundantly demonstrates that the resources mobilised through fiscal policy were inadequate.

Of the increase in revenue, a considerable proportion was taken up by the increase in non-development expenditures. Thus, of the increase of Rs. 187 crores in public revenues in 1955-56 as compared to 1950-51 as much as Rs. 110 crores was absorbed in non-development expenditure; the balance left for development expenditure being, therefore, only Rs. 77 crores. Besides, development expenditures on revenue account outside the Plan also increased steadily in the plan period so that of the fresh resources raised by taxation and the like, the amount available for the Plan as such turned out to be even smaller.[8] A part of the non-development outlay was of an unavoidable nature such as on flood relief, but a part of this could have been avoided by economies in administrative expenditure.

In a developing economy, it is an important pre-requisite of accelerated economic development that an increasingly larger proportion of the expanding level of national output be ploughed back into investment through the apparatus of public finance. This implies that the share of public revenues in the national income should tend to increase progressively. In 1950-51, total revenue receipts amounted to 8.1 per cent of the national income, whereas in 1955 56, this percentage was 10. Total tax revenues amounted to 6.6 per cent of the national income in 1950 51, and this percentage was 7.9 in 1955-56. Non-tax revenues stood at 1.5 per cent of the national income in 1950-51 and they amounted to 2.1 per cent of the national income in 1955-56.[9] Thus the growth in public revenues did not keep pace with the growth in national income and as a result, the apparatus of public finance was not effectively geared to the ploughing back of an increasingly larger proportion of national income into public savings.

Taking the Centre and the States separately, it is found that total tax revenues of the Centre amounted to 4.2 per cent of

the national income in 1950-51, whereas in 1955-56 (R.E.) this percentage was 4.7. As regards the States, their tax revenues amounted 2.3 per cent of the national income in 1950-51, whereas in 1955-56 (R.E.), this percentage was 2.7.[10] This means that tax policy was not used as an effective instrument of development finance for the public sector during the period of the First Five Year Plan.

As regards public borrowing, the *Review of the First Five Year Plan* observes, "A plan of development has necessarily to depend upon market borrowings to an extent, but this depends in the main on the extent to which private savers, individual and institutional, invest their savings voluntarily in government securities. Certain incentives can, no doubt, be offered, but these again have to be related to the other demands on private savings and the prevailing structure of interest rates. Beyond a point, therefore, reliance on the market borrowings makes the resources position for a development plan uncertain and carries with it the danger of potential inflation."[11]

RESOURCE MOBILISATION DURING THE SECOND FIVE YEAR PLAN

The Second Five Year Plan embodied a programme aimed at a significant stepping up of the level of investment both in the public and the private sectors of the economy. Therefore, it envisaged the mobilisation of domestic resources on a much larger scale than was necessary for the First Plan. It also assumed external assistance of a sizable amount. But the subsequent developments revealed that the assessment of resources necessary for the Plan as made by the planners was unrealistic and so the pattern of investment embodied originally in the Plan had to be modified and the size of the Plan had to be reduced in light of the resources position which developed subsequently.

The Plan proposed a financial outlay on development amounting to Rs. 4800 crores for the public sector. Of this amount Rs. 2559 crores was the proposed financial outlay on the plan of the Centre and Rs. 2241 crores on the plans of the states. There was a considerable accumulation of inflationary pressures just before the Second Plan began and these pressures

gathered momentum as the implementation of the Plan was accelerated. The Suez crisis of 1956 and the high prices prevailing in foreign markets made the prices of imported foreign machinery and capital goods higher. As a result the cost estimates of some of the projects in the Plan were raised. Some of the initial estimates in the Plan for some of the development projects were inadequate and their estimates, therefore, were raised subsequently. A few new projects of high priority were also included in the Plan after it was formulated. Therefore, it became apparent that the financial resources necessary for completing the Plan would be significantly higher than the total of Rs. 4800 crores proposed initially.

It was expected that the implementation of a plan of a large magnitude would be associated with serious stresses and strains in the economy. But due to the combined operation of a number of factors, these stresses and strains came much earlier than was expected. The wholesale prices had already begun to rise before the Plan commenced and the upward trend continued, punctuated by brief periods of stability. The price index was 89 in May 1955, (1952-53—100), and 114 in May 1959. This has been indicative of the growing inflationary pressures in the system. There took place a sharp adverse turn in the balance of payments in April 1956 and the deficit on current account in the balance of payments amounted to a total of Rs. 591 crores from April, 1956 to September, 1957. The total deficit on current account in India's balance of payments from January 1956 to December 1958 amounted to Rs. 684 crores; and this led to a large-scale depletion of foreign resources. The spurt in the level of investment combined with "the liberalisation of import policy geared to the increasing requirements of industrial development was a material factor in causing the strain on the balance of payments, besides exerting an upward pressure on domestic prices."[12]

These developments were an index of the growing disequilibrium between the available resources and the demands on them necessitated a reallocation of outlays and a readjustment of the pattern of investment embodied originally in the Plan. Besides, a downward revision in the total plan outlay was made from Rs. 4800 crores to Rs. 4500 crores so as to correspond to the resources position. As against the revised plan outlay of

Rs. 4500 crores, the available resources were estimated at Rs. 4200 crores, thus indicating a shortfall of Rs. 280 crores. This abundantly justified the criticism of the plan that it was based upon an unrealistic assessment of the availability of domestic and external resources.

As there had been a rise in the general level of prices during the plan period, the achievement of the physical targets embodied in the Plan would have called for a much larger financial outlay than Rs. 4800 crores originally proposed and even if this entire financial outlay could be incurred by the public sector during the Plan period, it was unlikely that the growth in real output would have been of the order envisaged in the Plan. This is because the investment in real terms would have been less due to the rise in prices even if the investments in monetary terms were of the same magnitude.

Mobilisation of Domestic Resources

The Planning Commission had estimated that the total plan outlay of the public sector amounting to Rs. 4600 crores in the Plan was financed to the extent of Rs. 2562 crores by domestic resources, Rs. 1090 crores by external assistance and Rs. 948 crores by inflationary finance.[13] This means that only 57 per cent of the Plan expenditure had been financed through domestic resources, 21 per cent through inflationary finance and 22 per cent through foreign grants and loans. Thus deficit financing and external finance constituted 43 per cent of the total resources and this was not a desirable development in a growing economy. Thus the domestic resources mobilised by the Central and state governments were inadequate.

The total outlay in the State Plans has been estimated to be of the order of Rs. 2082.56 crores for the Second Plan. 36 per cent of the outlay of the States as a whole financed through domestic resources, 56 per cent through Central financial assistance and 9 per cent through inflationary finance. Thus it virtually amounted to financial underwriting of the fulfilment of the States plans by the Centre and the domestic resources mobilised by the States have been quite inadequate. Thus, considered from the criterion of the mobilisation of domestic resources, the federal structure of public finance has not been

compatible with the conditions of an accelerated economic development. The mobilisation of domestic resources by the States has been much below expectations in spite of the fact that there took place a substantial transfer of revenues estimated at Rs. 160 crores over the Plan period[14] from the Centre to the States under the recommendations of the Second Finance Commission.

Of the total domestic resources at the Centre amounting to Rs. 732 crores for the first three years of the Plan, the surplus from current revenues is estimated at Rs. 305 crores, the contribution of the railways Rs. 129 crores, and loans from the public small savings and other capital receipts at Rs. 298 crores. Of the total domestic resources of Rs. 369 crores mobilised by the States during the first three years of the Plan, current revenues have constituted Rs. 134 crores of 36 per cent and loans from the public, small savings and other capital receipts have contributed Rs. 235 crores or 64 per cent. Thus out of the plan outlay of Rs. 2456 crores for both the Centre and the states in the first three years, only Rs. 439 crores or only 18 per cent was financed by resources from current revenues and this is a staggeringly low figure. This was in spite of the fact that there was considerable tax effort during the first two years of the Plan at the Centre. The biggest tax effort was made in 1957-58, but curiously enough, this was the year of the heaviest budgetary deficit. The volume of domestic resources in that year was estimated to have been about Rs. 62 crores lower than in 1956-57, primarily because of the decline in receipts from market loans. During 1958-59, a considerable improvement in loans as in small savings took place. As regards the mobilisation of resources from current revenues, the *Appraisal and Prospects of the Second Five Year Plan* observes, "The striking feature of the resources position over these years is that the balance available from current revenues for financing the Plan has remained more or less static, around Rs. 140-150 crores."[15]

The insufficiency of resources available to the Centre from current revenues was partly due to the transfer of Rs. 160 crores to the State under the Finance Commission's award and partly due to the increase in non-developmental expenditure such as increase in defence expenditure and the subsidies on food. "Thus, on balance, while a massive tax effort has been

made in recent years, the original gap of Rs. 400 crores in resources still remains more or less uncovered."[16]

THE TAX POLICY OF THE STATES AND RESOURCE MOBILISATION

In the States, the additional taxation of 1956-57 was expected to yield Rs. 8.7 crores in that year and Rs. 12.4 crores in a full year. For 1957-58, the corresponding estimates are Rs. 11.9 crores and Rs. 20.2 crores. In 1958-59, as against the tax effort of Rs. 20 crores envisaged by the State governments while formulating their plans for the year, the measures proposed in the budget of the year were estimated to yield Rs. 14 crores only. In the budget of 1959-60, the total sum expected to be raised from the proposals for additional taxation has been estimated to be only of a small amount of Rs. 4 crores.[17]

Thus for the first four years of the Plan, additional taxation in the states had been about Rs. 83 crores and the yield of these measures over the five years period was about Rs. 180 crores. This was about Rs. 45 crores below the target of Rs. 225 crores set in the Plan. The States were expected to mobilise resources amounting to Rs. 370 crores in all from current revenues. But during the first three years of the Plan resources from this source amounted to Rs. 135 crores and for the five-year period, the total at the tax rates prevailing at the end of the third year of the Plan was expected to be about Rs. 295 crores. As the resources expected from additional taxation in the fourth year of the Plan was of the order of Rs. 4 crores only, the total resources mobilised by the states from current revenues fell below the plan target.

Therefore, the substantial shortfall in the plan outlay in the States in the first three years of the Plan was "partly because of the administrative difficulties connected with the reorganisation of States, but in part, it reflects the inadequacy of resources available."[18] The strain on the resources of the States was caused by increase in non-developmental expenditure such as debt services, police, general administration and direct demand on revenue. Besides, there was an increase in the developmental expenditures of the States outside the Plan.

During the first four years of the Plan, the States raised

about Rs. 40.1 crores of resources from additional taxation by way of general sales tax and Rs. 3 crores from tax on motor spirit and diesel oil. On this basis, this would work out at Rs. 84 crores and Rs. 7 crores respectively for five years as against the combined target of Rs. 112 crores set in the Plan. Land revenue and irrigation rates in four years yielded about Rs. 3.5 crores which would work out at Rs. 8.6 crores over five years as against the combined plan target of Rs. 37 crores and Rs. 11 crores respectively for five years. Resources from betterment levy over this period amounted to Rs. 0.92 crore and for five years this amounted to about Rs. 2.5 crores as against the plan target of Rs. 16 crores which was exclusive of the yield of Rs. 37 crores to be made available to the Centre for repayment of loans. The yield from additional taxation with respect to agricultural income tax was Rs. 3.3 crores over four years and this amounted to Rs. 7.5 crores over the Plan period as against the target of Rs. 12 crores in the Plan. The additional resources from electricity duties, tax on motor vehicle including tax on passengers and goods, stamp duties and registration and excise duties were estimated at Rs. 3 crores, Rs. 7.5 crores, Rs. 1.9 crores and Rs. 1.9 crores respectively for four years and, on this basis, these amounted to about Rs. 8 crores, Rs. 17 crores, Rs. 4 crores and Rs. 3.8 crores over five years against the plan target of Rs. 6 crores, Rs. 10 crores, and Rs. 4 crores respectively. Others yielded additional resources amounting to Rs. 35 crores over five years as against the target of Rs. 17 crores and these represented resources mainly from local property taxes.

The tax policy of the States in this period reveals a number of striking features. Firstly, there was preponderant reliance upon commodity and outlay taxes for the mobilisation of resources. This was inevitable for two reasons. In the first place, the Constitution has delimited the fiscal competence of the States in such a manner that they have to rely upon outlay taxes for resources. In the second place, dependence upon outlay taxes is inevitable for financing a programme of planned development in the framework of a mixed economy.

Secondly, the resources mobilised by the States from land taxation were not only much below expectations but they were quite meagre. It is argued that a developing economy has to mobilise a very large volume of resources from the agricultural

sector through land taxation. This is an inevitabte logic of accelerated economic progress. Thus, the policy of the states with regard to the mobilisation of resources through land taxation has not been compatible with the inevitable logic of planned and accelerated economic development.

Thirdly, the total resources mobilised by the states through additional taxation were quite inadequate and the States did not follow a dynamic tax policy which is essential in a developing economy if its rate of growth is not to be hindered by the insufficiency of resources.

The states did not make adequate efforts to harness the tax potentials existing in their sphere, and this has been especially true with regard to land taxation and betterment levies. It is necessary that the tax potentials existing in the rural sector of the economy be fully exploited for mobilising additional resources for public investment.

Thus, the experience of the mobilisation of resources during the First and the Second Plan demonstrated that the federal structure of public finance has not been compatible with the criterion of mobilising maximum resources through the apparatus of taxation.

The overall conclusion that emerges as a result of the study of the effort at resource mobilisation in India during the period of the First and the Second Plan is that inadequacy of resources has been an important bottleneck in the process of accelerated economic growth. One thing that stands out very clearly is that in the raising of domestic resources, exclusive reliance was placed upon the traditional methods of public finance and no planned and conscious effort was made to develop an appropriate organisation for the mobilisation of surplus labour in the rural sector for capital formation and for supplementing the supply of real resources. Besides, though there took place a significant expansion of the public sector, no significant investible surplus was mobilised through the mechanism of the price policy of the public undertakings except, of course, the railways. It is not possible to mobilise resources of a considerable magnitude through exclusive reliance upon the traditional methods of public finance.

Resources for the Third Plan

The Third Plan had proposed a total outlay of Rs. 7500 crores for the public sector as a whole for the period 1961-66 but the actual outlay amounted to Rs. 8577 crores. Of this amount Rs. 5021 crores or 58.5 per cent was financed through domestic budgetary resources, Rs. 2423 crores or 28.3 per cent through external assistance and Rs. 1133 crores or 13.2 per cent through deficit financing. The share of the Centre in the total public sector outlay was of the order of Rs. 4412 crores while that of the States amounted to Rs. 4165 crores. The Centre financed Rs. 3500 crores of its outlay through domestic budgetary resources, Rs. 2423 crores through external assistance and Rs. 1004 crores through deficit financing. As regards the States, they financed Rs. 1521 crores of their outlay through domestic budgetary resources, Rs. 2515 crores through Central financial assistance and Rs. 129 crores through deficit financing. This means that 61 per cent of the plan outlay of the States was financed through Central assistance indicating the tendency to fiscal Centralisation and growing dependence of the States on the Centre for financing their development plans. This means that the Centre virtually underwrote the financial inplementation of the States plans.

Table 5.1 indicates the outlay of each State on the Third Plan and the Central Financial assistance to finance the State plans:

The total resources mobilised by the Centre through additional taxation including measures to increase the surplus of public enterprises amounted to Rs. 2277 crores while these mobilised by States amounted to Rs. 615 crores. This means that the Centre made a massive effort to mobilise resources through additional taxation, but the effort made by the States was inadequate. This may, however, be only a partial explanation of the performance of the two layers of government. The basic explanation seems to be that the resources to be tapped by the Centre are more responsive to changes in tax rates and national income while those of the States are less responsive. Besides the additional tax effort of the Centre lay essentially in the field of excise taxation which, therefore, limited the potential of the States to raise resources through commodity taxes

such as sales taxation.

There developed two other features in the performance of the states with regard to resource mobilisation through additional taxation to finance their plan outlays. While the relatively more developed States such as Maharashtra, West Bengal,

TABLE 5.1

(amounts in crores of rupees)

Sl. No.	*States*	*Total outlay*	*Central assistance*	*Central assistance as per cent of total outlay.*
1.	Andhra Pradesh	344.78	220.5	64.0
2.	Assam	132.24	99.9	87.0
3.	Bihar	331.74	215.9	65.1
4.	Gujarat	237.64	111.6	47.0
5.	Jammu & Kashmir	61.24	61.5	100.4
6.	Kerala	181.59	121.7	67.0
7.	Madhya Pradesh	288.35	219.5	76.1
8.	Maharashtra	433.60	160.8	38.5
9.	Mysore	250.69	156.5	62.4
10.	Nagaland	10.8	10.8	100.0
11.	Orissa	224.06	136.7	61.0
12.	Punjab	254.69	134.4	52.9
13.	Rajasthan	210.69	161.4	76.6
14.	Tamil Nadu	342.33	186.8	54 6
15.	Uttar Pradesh	560.25	356.2	63.6
16.	West Bengal	300.48	155.1	51.6
	Total	4164.75	2515.3	60.4

Punjab, and Tamil Nadu raised larger resources through additional tax measures, the performance of the relatively less-developed States was very unsatisfactory. This, therefore, led to a number of consequences. In the first place the relatively less developed States had their dependence on the Centre further increased to finance their Plan outlay. Secondly, this had the effect of widening the disparities in the development effort of the various States and so accentuating inter-regional imbalances in levels of development.

Besides, the resources mobilised by the States tended to be

eaten up in their growing non-plan expenditure. In view of this the States made a representation to the Centre that unless the additional resource mobilisation undertaken by them was allowed to be utilised for augmenting their plans, there could be little to enthuse the people to put up with the additional tax burden and it would be difficult for the State governments to introduce measures of additional taxation and resource mobilisation contemplated by them. After careful consideration of the matter, the Planning Commission requested the Ministry of Finance to extend special accommodation to such States as had non-plan gaps in their resources on the condition that the gap in the resources of the States would be contained and the States concerned would make an effort to increase their Plan outlays through additional resource mobilisation. This was accepted by the Central government. Since then the Centre has been making a transfer of resources to the State to fill up their non-plan gaps as well. But there was no corresponding increase in tax effort by the States to increase their plan outlays in the Third Plan.

The dependence of the States on central financial assistance to finance their plan outlay had varied from 100 per cent in case of Jammu and Kashmir and Nagaland to 38.5 per cent in case of Maharashtra and 47 per cent in case of Gujarat. The complaint of the States of Gujarat and Maharashtra, however, was that since they received relatively lower financial assistance to finance their plans, this virtually amounted to penalising efficiency.

During the first three plans the allocation of resources from the Centre to the States for financing their five year plans was not determined on the basis of any objective criteria. The allocation was made by the Planning Commission largely on an ad hoc basis.

Resources for the Fourth Five Year Plan

The total development outlay for the public sector has been estimated at Rs. 16,487 crores out of which 12,898 crores was financed through domestic resources, 1066 crores through deficit financing and 2523 crores through external assistance. This means that 77.5 per cent of the expenditure was financed through domestic resources, 6.5 per cent through deficit

financing and 15 per cent through external assistance.

The outlay in the plans of the states was about Rs. 7000 crores as against the proposed outlay in the Fourth Plan (Final) of Rs. 6606.4 crores. The outlay in the State Plans had been proposed to be financed to the extent of 47 per cent through the States' own resources and the remaining 53 per cent through central financial assistance. The volume of financial assistance from the Centre for the financing of their plans diminished in the Fourth Plan as compared to that in the Third Plan. The following table indicates the extent of the financing of the State plans through central financial assistance as proposed in the Fourth Plan (Final):

TABLE 5.2

(*amounts in crores of rupees*)

Sl. No.	*States*	*Total outlay*	*Central financial assistance*	*As per cent of total outlay*
1.	Andhra Pradesh	420.50	240.0	57.1
2.	Assam	261.75	220.0	84.0
3.	Bihar	531.28	338.0	63.6
4.	Gujarat	455.00	158.0	34.7
5.	Haryana	225.00	78.5	34.9
6.	Jammu & Kashmir	158.40	145.0	91.5
7.	Kerala	258.40	175.0	67.7
8.	Madhya Pradesh	383.00	262.0	68.4
9.	Maharashtra	898.12	245.5	27.3
10.	Mysore	350.00	173.0	49.4
11.	Nagaland	40.00	35.0	87.5
12.	Orissa	222.60	160.0	71.9
13.	Punjab	293.56	101.0	34.4
14	Rajasthan	302.00	220.0	72.8
15.	Tamil Nadu	519.36	202.0	38.9
16.	Uttar Pradesh	965.00	526.0	54.5
17.	West Bengal	322.50	221.0	68.5
	Total	6606.47	3500.0	53.0

Though the above figures indicate an improvement in the overall financial position of the states, the improvement was only of a marginal character. In case of some States, however,

the improvement was quite significant. In case of Maharashtra the dependence on central financial assistance fell from 38.5 per cent in the Third Plan to 27.3 per cent in the Fourth and in case of Punjab from 52.9 per cent in the Third Plan to 34.4 per cent in the Fourth. But in case of some States the dependence actually increased. In case of Kerala it increased from 67 per cent in the Third Plan to 67.7 per cent in the Fourth, in case of Orissa from 61 per cent to 71.9 per cent and in case of West Bengal from 51.6 per cent to 68.5. per cent.

The major portion of the Central Financial assistance to finance the State Plans was in the form of plan loans and it has been estimated that plan loans amounted to Rs. 2805 crores or 80 per cent of the total central financial assistance with their concomitant effect of increasing the debt burden on the states.

The improvement, however, does not seem to reflect any major attempt by the States to raise additional resources through exploitation of their revenue resources. In some cases there was a deterioration. The improvement was caused largely as a result of recommendations of the Fifth Finance Commission which led to a significant increase in the total resources transferred to the States under shared taxes from Rs. 1196 crores in the third plan to Rs. 4562 crores in the Fourth Plan which represented a four-fold increase while the plan outlays of the states in the Fourth Plan was approximately double of that in third plan. Besides the Centre transferred a total amount of Rs. 1948 crores as non plan grants and Rs. 3636 crores as non-plan loans to the States. Thus the total resources (net) transferred to the States was of the order of Rs. 11395 crores during the Fourth Plan and this did not include the assistance giving to the States for clearing their overdrafts with the Reserve Bank of India.

The total picture, therefore, which emerged at the end of the Fourth Plan was not at all encouraging. During the Fourth Plan the Central Government, besides giving loans to States for plan and non-plan purposes like meeting relief expenditure on account of natural calamities, purchase of fertilizers, loans out of small savings collections and for tiding over way and means difficulties, also initiated, on the recommendation of the Fifth Finance Commission, a scheme of special accommodation beginning with 1969-70 to meet the overall non-plan gaps of

some States. The amount of non-plan grants to States during the Fourth Plan was of the order of Rs. 3636 crores. But it is these discretionary transfers which were not based on any objective criteria of allocation that became highly controversial subjects in inter-governmental financial relation in India in the recent years.

During the Fourth Plan, the allocation of resources from the Centre to the States for financing their plans came to be determined on the basis of the Gadgil formula (after the name of late Prof. D.R. Gadgil, Deputy Chairman of the Planning Commission). This formula attempted to achieve a compromise between different criteria to redress the specific disabilities of states or to reward a relevant effort measured on an equitable basis. It gave 60 per cent weightage to population, 10 per cent to per capita income of the State, 10 per cent for per capita tax effort and 10 per cent for continuing major irrigation and power schemes and 10 per cent to special problems of particular States.

The Fifth Plan and Development Finance

The Draft Fifth Plan had made a provision of Rs. 37250 crores as the development outlay for the public sector, but in the revised plan the development outlay was fixed at Rs. 39303 crores excluding provision for inventories. The budgetary resources of the Central and State governments were estimated to provide Rs. 32115 crores or 81.7 per cent of the total resources required for financing the plan. External assistance was to account for Rs. 5834 crores or 14.9 per cent of the outlay and the balance of the plan outlay amounting to 3.4 per cent of the total was estimated to be met through deficit financing.

The total development outlay of the States in the revised Fifth Plan was put at Rs. 18717 crores. Of this total amount Rs. 2848 crores was to be provided in terms of balance from current revenues at 1973-74 rates of taxation while the gross surplus of public enterprises was put at a negative figure of Rs. 703 crores because of substantial losses by State Electricity Boards in spite of tariff revisions by 12 State Electricity Boards. Other State enterprises such as States Road Transport

Corporations and State irrigation works also incurred losses. The States also benefited to the tune of Rs. 1000 crores as their share in measures of additional resource mobilisation undertaken by the Centre in terms of additional tax measures. The Central assistance to finances the State plans was put at Rs. 6000 crores representing one-third of the total outlay on the State Plans. This means that the dependence of the States to finance their plan outlays has progressively declined from 61 per cent in the Third Plan to 53 per cent in the Fourth Plan and 33 per cent in the Fifth Plan.

During the Fifth Plan advance plan assistance was made to certain States by the Centre for meeting the gap in their resources for financing the inescapable requirements of Plan outlay in the core sectors. Further, advance Plan assistance was given for accelerating the implementation of selected irrigation and power projects in 1975-76. In accordance with the recommendations of the Sixth Finance Commission, advance plan assistance was also given for development works taken up by the states in connection with relief from natural calamities.

A lumpsum allocation was made for Jammu and Kashmir, Assam and Nagaland under the Gadgil formula. Accordingly lumpsum allocations for the Fifth Plan period were made for these States and Himachal Pradesh, and other North Eastern States and Sikkim which became a State after the Gadgil formula was evolved. The balance of the Central assistance was distributed among the remaining States on the basis of updated calculations in terms of the Gadgil formula.

The general pattern of Central assistance for financing the State Plans was, however, based on 30 per cent grant and 70 per cent loans along with the liberalised pattern for hill States and hill and tribal areas.

The allocation of Central assistance to finance the State plans, however, did not represent the true picture of the aggregate resource transfers to the states The Centre made non-plan grants amounting to Rs. 3286 during the first three years of the Fifth Plan which on an average amounted to Rs. 1100 crores per year which compared with the annual average for the Fourth Plan was much higher; the annual average for the Fourth Plan being Rs. 836 crores. Besides the Centre made non-plan loans to the States which during the first three years

of the plan amounted to more than Rs. 1300 crores. These non-plan grants and loans represent purely discretionary resource transfers not based on any objective criterion and they have been very controversial issues in inter-Governmental financial relations in India.

The improvement in the finances of the States reflected largely the financial impact of the resource transfers under the recommendations of the Sixth Finance Commission. According to the recommendations of the Sixth Finance Commission, accepted by the Central Government, there was a larger devolution of resources from the Centre to the States than under these of the Fifth Finance Commission. The States benefited from the recommendations of the Sixth Finance Commission in two ways. Firstly, the Commission recommended a substantial increase in transfer of resource from the Centre to the States, particularly in grants in-aid under Article 275 of the constitution for covering non-plan revenue deficits of states and for improvement in administrative and social services in some backward states where the level of these services was lower than the all-India average. Such grants-in-aid to states have been estimated to increase from Rs. 711 crores during the Fourth Plan to Rs. 2510 crores during the Fifth Plan. Secondly the share of the states in the divisible pool of taxes was enlarged. The estimated share of states in Central taxes and duties amounted to Rs. 7099 crores during the Fifth Plan period as compared with Rs. 4605 crores during the Fourth Plan period. Besides the Sixth Finance Commission which reviewed the non-plan capital gap of the States for the first time recommended consolidation of outstanding loans from the Centre and revision of terms of repayment as a result of which the States were expected to get a debt relief of Rs. 1970 crores over a period of Five Years. Altogether the States were estimated to derive an additional benefit of Rs. 6263 crores over the Fifth Plan period.

Development Finance for the Sixth Plan

The draft Sixth Plan (1978-83) has proposed a total public sector outlay of Rs. 69,380 crores which represents 59.7 per cent of the total Plan outlay. The allocation of plan outlay

between the Central Plan and those of the States has not been worked out as yet. The National Development Council in its meeting held in March 1978, however, welcomed the larger role assigned to the State Governments in the Draft Plan by the Planning Commission in development planning and execution. This, therefore, calls for a change in fiscal arrangements since this would mean that the fiscal commitments of the States would increase in the financing of the Plan. The existing fiscal arrangements based on the Gadgil formula have been found to be inadequate and unsatisfactory by the States. Besides the question has also been raised with regard to the financial responsibilities for centrally sponsored scheme under the plan.

The National Development Council, therefore, appointed a Committee under the chairmanship of Prof. D.T. Lakdawala, Deputy Chairman of the Planning Commission to go into the fiscal arrangements for the financing of the plan and also to review the Gadgil formula and the scope of the centrally sponsored schemes in the Plan. In the meantime the Seventh Finance Commission would be submitting its recommendations with regard to the allocation of shared taxes, grants under Article 275 of the constitution and non-plan gaps in the States' finances during the Sixth Plan and other questions included in its terms of reference. The Committee, therefore, took into account the recommendations of the Seventh Finance Commission before presenting its report to the next meeting of the National Development Council.

A number of issues, however, have been raised with regard to the financing of the Plan and allocation of resources to the State. The States are extremely unhappy about the existing arrangement for allocation of central assistance to finance the State Plans under which 70 per cent of the assistance is given as loan which puts a burden on the finances of the States and this burden has been progressively increasing. They are, therefore, in favour of the resource allocation being made in terms of larger allocation from shared taxes which would be free from such effects and would be compatible with their financial autonomy. The States, at the same time, have been demanding greater freedom to raise loans from the market to finance their development schemes.

The Gadgil formula was based on achieving a compromise

between difficult criteria regarding allocation of resources among States to finance their plan outlays from central financial assistance. The formula, however, has been regarded as extremely crude in nature. On the one hand by giving weightage to population, per capita income and special problems of some States, it has attempted to correct inter-state disparities in levels of development. Thus the allocation of Plan resources from the Central government has been attempted to favour the less development and comparatively backward States. The more developed States, however, are unhappy because only 10 per cent. weightage is given in the formula to per capita tax effort, though such States do not have, in all cases, the record of optimising resources through additional taxation even if they had the potential to do so. Some of them have the grievance that as a result of greater effect to mobilise resources from taxation, they have been deprived of having larger Central financial assistance to finance a plan of larger size.

Another question which has also arisen in this regard is whether devolution of larger resources to States should be made within the existing constitutional framework or whether the constitution should be amended to assign more tax resources to the list of shared taxes among the Centre and the states. Under the existing constitutional arrangement only two major tax resources are not shared between the Centre and the states; they being the corporation tax and customs duties. The major portion of the net proceeds of the divisible part of income tax is assigned among the States under the recommendations of the Finance Commissions. The States have put forward a strong case for distributing the proceeds of the corporation tax also among them, but the distribution of the proceeds from customs duties would raise enormous complications.

It is, however, possible to make a larger devolution of resources to the states under the existing constitutional arrangements. This can be achieved by assigning to the states a share in a larger number of Central excise duties which now yield substantial revenues. The Seventh Finance Commission has realised the importance of this matter. By widening the number of excise duties the proceeds of which can be shared with the States, a greater buoyancy can be imported into the finances of the States. There are a number of important considerations

why devolution of resources to the States through shared taxes is preferable to devolution by grants.

It is, however, important to consider the question of the finances of the states in a proper perspective. Though the States are quite justified in pressing for larger flow of resources from the Centre, they should also optimise their efforts to utilise their tax potentials. There exists scope for augmenting the resources of the states for financing their plans. As the Planning Commission has pointed out, "the return from investments in Central and State enterprises, is at present below the fair return allowed when fixing prices for the private sector, and should therefore be raised by economies and price adjustments to a post-tax level of 10 per cent. Water and power rates will need upward revision in order to provide a reasonable return on the rising investments in these sectors. In view of the massive investments proposed to be made in agriculture and rural works of various kinds, earnest efforts must now be made to recover a part of the increased rural income for re-investment in the public sector. In view of the evidence of unequal distribution of rural assets (especially land) the equitable way of doing this would be through appropriately structured taxes on agricultural income or progressive surcharges on land revenue. As regards taxation, . . . a part of the capital gains on developing urban land and property may be appropriated to the State treasuries."[17]

The Draft Sixth Plan has envisaged that Rs. 13000 crores have to be mobilised by the Centre and the States by way of additional taxes and by raising the surpluses of their respective public enterprises.

References

1. *Review of the First Five Year Plan*, 1957, p. 24.
2. *ibid.*
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5. *ibid.*, p. 27.
6. *ibid.*, p. 28.
7. *ibid.*, p 35.
8. *ibid.*, p. 37.
9. *ibid*, p. 38.
10. Tripathy, R.N, *Fiscal Policy and Economic Development in India*, 1970.

11. *Review of the First Five Year Plan*, p.37.
12. *Appraisal and Prospects of the Second Five Year Plan*, May, 1958, p. 4.
13. The actual figures may be somewhat different, but the divergence is not expected to be significant.
14. *ibid.*, p. 12.
15. *ibid.*, p. 10.
16. *Appraisal and Prospects of the Second Five Year Plan*, p. 12.
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6

FISCAL IMPACT OF FEDERALISM IN INDIA

The Impact of National Economic Planning on the Structure of Indian Public Finance

The experience of the planning and implementation of a programme of planned development under the Five Year-Plans has amply demonstrated that under a federal structure of public finance in India, it has been possible not only to plan quite effectively a development policy on an integrated basis, but also to carry out that policy quite successfully and in accordance with a scheme of allocation of resources devised and modified by the Central planning authorities. Thus, the effective co-ordination in the development policy of the public sector as a whole, achieved under the Five-Year Plans, has tended to lead to the emergency of a much more unified structure of public finance in India. As a result, national planning, while proceeding largely through consultation has tended to widen the role of the Central Government for a number of reasons noted below:

(*a*) The Central Government has undertaken to underwrite the implementation of the development plans of the public sector. This is amply borne out by the experience of the implementation of the development plans of the States during the Five-Year Plans, when the implementation of their plans was not allowed by the Centre to be hindered owing to the lack of finance; and the impact of the widening budgetary deficits in the resources of the States for financing their plans was transmitted to the Central budgets in the form of the Centre making a progressively larger transference of resources to the States in the form of loans and grants. Thus, the power of the purse has been one of the main instruments for the extension of Central control over the development policy of the States.

(*b*) National planning has determined, both for the Centre and the states, the directions in which the available resources of the public sector may be used; and the Centre has developed the necessary institutional apparatus for seeing that the States discharge their part of the obligations as laid down in the Plan by the Central planning authorities.

(*c*) Important new impulses and drives have emanated from the Centre and developed into nation-wide programmes. In some cases, part of the direction and finance has come from the Centre, but the execution has been wholly with the States, such as the "Grow More Food Campaign", the National Malaria Eradication Programme, the Welfare of Backward Classes and the Community Development Projects, National Extension Service, etc. But the Community Projects and National Extension Service have been distinct in quality. They have called for finance and direction from the Centre, but their real meaning lay in the fact "every agency in the administration should work with and not merely for the people."[1]

(*d*) The distribution of outlay proposed in the Five-Year Plans between the Central and the State governments was not a correct index of the schemes which should fall within the respective spheres of the Central and state governments in terms of the delimitation of functions envisaged in the Constitution. The Central multi-purpose schemes were really the schemes of the States; but in view of the inter-state territorial coverage of these projects, the exact distribution of their financial liability between the states concerned could not be foreseen in the initial stages; and so these schemes were included in the plan of the Centre. Besides, the provision in the First Plan for major irrigation and other local works, and five major irrigation and power projects, scarcity-affected areas, rehabilitation of displaced persons, basic and social education, industrial housing, etc., were shown as part of the development programme of the Central Government though they belonged to the states. With the progress of the Plan, the financial and operational responsibilities of the States in these schemes were worked out; and they have been implemented by them largely under the guidance of the Centre, and with the help of considerable volume of Central financial assistance. Thus, the initial political assumptions in the context of which planning began in India have

become much less important; and national planning has tended to weaken considerably the lines of demarcation between the Centre and the states. In place of the initial political assumption based upon formal distribution of powers and responsibilities, there has begun a transition to a faithful partnership in the process of planned development between the Centre and the States, and the States have begun conforming to the national pattern of social and economic development.

The Impact of Central Finances on the Structure of Public Finance of the States

As a result of the progressive expansion in the transference of resources from the Central Government to the states, especially since the beginning of the post-war period, the federal structure of public finance in India has tended to undergo a fundamental transformation. The revenues of the Centre and of the states have tended to coalesce in an important manner, and any elasticity in Central revenues has tended to be felt in the state revenues also to a very substantial extent. Thus, the element of rigidity which used to characterise the revenue resources of the states, in the context of their expanding fiscal needs, has tended to become a phenomenon of diminishing importance.

Such a tremendous impact of the Central finances on the finances of the states has very great importance for a concerted fiscal policy, both from the point of view of accelerating the tempo of economic development as well as of promoting a counter-cyclical policy, because the Centre has acquired a large measure of control over the public expenditure policy of the States.

During the period of post-war planning, in spite of the failure of the Central Government to keep up its promise of underwriting the financial implementation of the development schemes of the States, 20.8 per cent of their aggregate development expenditure during 1946-51, and 20.9 per cent of their development expenditure during 1946-50 were financed through Central grants and loans respectively. The development grants constituted a very significant proportion of the total development finance of some of the backward and financially weaker

states such as Assam, East Punjab and Orissa. A very large proportion of the loans was for heavy capital expenditure on multi-purpose river valley projects. This was indicated by the large proportion of the total development expenditure of East Punjab and Orissa having been financed through the medium of Central loans on account of capital expenditure on the Bhakra-Nangal and the Hirakud projects situated in these states respectively.

The process of planned economic development in the Indian economy during the Five-Year Plans has produced a number of fiscal effects which have fundamentally transferred the structure of Indian public finance in a number of other ways. Firstly, as the total public expenditures of the states increased in a much greater proportion to their own resources, they have been faced with increasing gaps in their resources which have been filled up through Central loans and grants. This has strengthened the process of fiscal centralisation and financial dependence of the states on the Central resources so much so that in the opinion of some people they have been reduced to the position of municipalities. While the total expenditures of the states both on revenue and capital account amounted to Rs. 543.9 crores in 1951-52, they increased to Rs. 912 crores in 1955-56 at the end of the First Plan, to Rs. 1478.3 crores in 1960-61 at the end of the Second Plan, to Rs. 2823 crores in 1965-66 at the end of the Third Plan and to Rs. 6701.1 crores at the end of the Fourth Plan in 1973-74. Thus the total public expenditures of the states increased 13-fold by the end of the Fourth Plan as compared to the beginning of the First Plan. But their own resources both tax revenues and non-tax revenues which amounted to Rs. 326.69 crores in 1951-52 increased to Rs. 2639.6 crores in 1973-74 at the end of the Fourth Plan. Thus, there was an increase of only a little above 8-fold in the states' own resources. The gap in resources stood at Rs. 217.21 crores in 1951-52, increasing to Rs. 4061.5 crores at the end of the Fourth Plan.

The gap in the states' resources has further widened in the Fifth Plan as indicated by the fact that the gap in Third Plan resources above was estimated at Rs. 6000 crores.

In the year 1970-71 the States' own tax revenues as a per cent of their total revenues at 1969-70 rates of taxation were

estimated as shown in Table 6.1

TABLE 6.1

(Amounts in lakhs of rupees)

State	*States' Own Tax Revenues* @	*Total Revenues* @	*States' Own Tax Revenues as a per cent of Total Revenues (1 as per cent of 2)*
	1	2	3
Andhra Pradesh ...	12467	23088	54.0
Assam ...	2873	10526	27.3
Bihar ...	8220	21870	37.6
Gujarat ...	8964	17939	50.0
Haryana ...	3624	7502	48.3
Jammu and Kashmir ...	735	5469	13.4
Kerala ...	6451	13942	46.3
Madhya Pradesh...	7902	21198	37.3
Maharashtra ...	24161	40780	59.2
Mysore ...	9436	19372	48.7
Nagaland ...	24	2713	0.9
Orissa ...	2772	10800	25.7
Punjab ...	7351	13590	54.1
Rajasthan ...	5730	15673	36.6
Tamil Nadu ...	12778	25248	50.6
Uttar Pradesh ...	13457	39042	34.5
West Bengal ...	12900	26609	48.5
Total ...	139845	315361	44.3

It will be seen from the above Table that the States' ownl tax revenues amounted to only 44 per cent of their tota revenues in 1970-71; the total revenues included their share in shared taxes and Central grants as well their own non-tax revenues. In the year 1970-71, however, the states' own non-tax revenues were estimated at Rs. 539 crores or 27.8 per cent of their own revenue receipts or 17 per cent of their total revenues. Thus the total own tax and non-tax revenues of the States in that year amounted to 61 per cent of their total revenues, the difference having been made up by their share in shared taxes

and Central grants. These figures, however, do not include those of receipts on capital account.

In 1973-74 at the end of the Fourth Plan, the total tax revenues of the states amounted to Rs. 2013.6 crores which worked out as 42.1 per cent of their total revenues and this was less than what it was in the beginning of the Plan. The total own tax and non-tax revenues of the States in this year amounted to Rs. 2639.6 crores which worked out as 54 per cent of the total revenues of the states. Thus the gap in their resources on revenues account had increased from 39 per cent in 1970-71 to 46 per cent in 1973-74.

This abundantly demonstrates that the resources of the States have not been adequately responsive to their needs as dictated by their growing expenditures determined by the logic of economic planning and development.

Thus the result has been that an increasing proportion of the expenditures of the States has been financed through the allocation of resources from the Centre as indicated in Table 6.2.

It appears from Table 6.2 that in 1951-52, 24.9 per cent of the total expenditure of the States was financed through resources made available by the Centre, and by the end of the First Plan this increased to 38.9 per cent. This had increased to 41.4 per cent at the end of the Second Plan, and during the Fourth Plan period as a whole resources made available by the Centre financed 41.5 per cent of the total expenditure of the States.

Since the Third Plan, apart from plan grants and loans, non-plan grants and loans have also been made to the States from the Centre. The flow of resources has assumed three forms: (1) allocation from shared taxes, (2) grants under the recommendations of the Finance Commission and Planning Commission as well as non-plan grants which are purely discretionary and (3) loans under the recommendations of the Planning Commission for financing State plans and non-plan loans which are discretionary. The share of the three components of resource flows has been shown in Table 6.3.

The figures show a number of significant trends. By the end of the Third Plan the contribution of shared taxes has tended to decline, but significantly increased during the Fourth Plan as a result of the recommendations of the Fifth Finance

TABLE 6.2

(Crores of Rupees)

Year	Resources made available by the Centre					Expenditure of States			Percentage of		
	Shared Taxes	Grants	Loans Gross	Loans Net	Total (2+3+5)	Revenue Account	Capital Account	Total (7+8)	(2+3) to (7)	(5) to (8)	(6) to (9)
1	2	3	4	5	6	7	8	9	10	11	12
1951-52	52.9	33.9	60.8	48.6	135.4	392.6	151.3	543.9	22 1	32.1	24 9
1952-53	73.8	36.0	92.0	78.2	188.0	416.9	155.5	572.4	26.5	50 3	32.8
1953 54	72.8	45.3	124.0	110.8	228.9	446.5	176.8	623.3	26.5	62.7	36 7
1954-55	71.6	51.4	193.4	174.8	297.8	494.4	205.9	700.3	24.9	84.9	42 5
1955-56	81.4	48.2	249.5	225.5	355.1	604.1	307.9	912.0	21.5	73 2	38.9
Total First Plan Period	325.5	214.8	719.7	637.9	1,205.2	2,354.5	997.4	3,351.9	24.1	64.0	36.0
1956-57	78.2	38.8	201.4	164.0	281.0	628.4	319 4	947.8	18.6	51.3	29.6
1957-58	120.9	114.4	276 0	215.3	450.6	683.9	347.2	1,031 1	34.4	62.0	43 7
1958-59	162.1	141.5	293.7	232.0	535.6	765.1	357.3	1,122.4	39.7	64.9	47.7
1959-60	169.9	181.6	275.6	193.9	545 4	896.8	396.5	1,266 3	40.4	48.9	43.1
1960-61	179.0	224.1	328.1	232.7	635.8	990.4	487.9	1,478.3	40.7	47.7	43.0
Total Second Plan Period	710.1	700.4	1,374 8	1,037.8	2,440.4	3,937.6	1,908.3	5,845.9	35.8	54.4	41.7
1961-62	178.4	214.8	452.4	318.5	711.7	1,121.3	509 1	1,630 4	35.1	62.6	43.7
1962-63	224.1	219.9	523.5	378.8	822.8	1,260.9	546.7	1,807.6	35.2	69.3	45.5
1963-64	259.5	234.0	624.0	444.6	938 1	1,412 5	689.7	2,102.2	34.9	64 5	44 6
1964-65	257.9	285.8	680.1	464.1	1,007.8	1,584.7	771.6	2,356 3	34.3	60.1	42.8
1965-66	276.1	348.4	821.4	545.2	1,169.7	1,892.2	930.8	2,823.0	33.0	58.6	41.4

Total Third Plan Period	1,196.0	1,302.9	3,101.4	2,151.2	4,630 1	7,271 6	3,447.9	10,719.5	34.4	62.4	43.4
1966-67	372.6	413 1	919 8	638 5	1,424 2	2,194 3	869.6	3,063.9	35.8	73.4	46.5
1967-68	415.7	479 0	877.5	492.5	1,387.2	2,333,9	887.1	3,221.0	38.3	55.5	43.1
1968 69	491.0	507.2	895 4	321.8	1,320.0	2,647.5	979.8	3,627.3	37.7	32.8	36.4
	1,279.3	1,399.3	2,692.7	1,492.8	4,131.4	7,175.7	2,736.5	9,912 2	37.3	53.1	41.7
Total Annual Plans (1966-67 to 1968 69)											
1 69-70	621.7	536.1	1,036.1	398.3	1,556.1	3,101.4	936.7	4,039.1	37.3	42.5	38 5
1970-71	755.4	570.1	1,011.7	346.7	1,672.2	3,389.8	1,079.3	4,469 1	39.1	32.1	37.4
1971-72	945.0	923 0	1,200.0	357.0	2,225.0	4,038 6	1,267.1	5,305 7	46.3	28.2	41.9
1972-73 (R E)	1,066.0	953.9	1,932.1	1,207.1	3 227 0	4,782.6	1,564.0	6,346.6	42 2	77.2	50.8
1973-74 (B E)	1,136.0	853 6	1,328.4	478 4	2,468.0	5,214.0	1,487.1	6,701.1	38.2	32 2	36 8
Total Fourth Plan Period	4,524.1	3,836.7	6,508.3	2,787.5	11,148.3	20,526.4	6,335.2	26,861.6	40 7	44.0	41 5

Commission. There has been wide variation in the relative importance of grants in the total resources, while the importance of loans tended to increase till the end of the Third Plan. It has, however, tended to decline during the Fourth Plan.

TABLE 6.3

(in per cent)

Year	*Shared taxes*	*Grants*	*Net loans*	*Total*
1951-52	38.5	25.2	36.3	100.0
1955-56	22.5	13.5	64.0	100.0
1960-61	28.1	35.2	36.7	100.0
1965-66	23.6	29.7	46.7	100.0
1973-74	46.0	34.6	19.4	100.0

The proportion of the flow of resources which has assumed the form of loans to States has produced very serious effects on their finances because of the burden involved. The indebtedness of the States to the Centre has increased in the manner as shown in the Table 6.4.

TABLE 6.4

Debt position of States

At the end of *(in crores of Rs.)*

	1951-52	*1955-56*	*1960-61*	*1965-66*	*1968-69*	*1973-74*
(a) Loans from the	238.54	876.07	2015.81	4100.92	5889	8688
Central Government	(53.7)	(71.0)	(73.5)	(74.5)	(75.1)	(74.7)
(b) Total Debt	445.28	1231.94	2737.17	5444.86	7374	12450
	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)

(Figures in brackets indicate percentage)

The above figures show that of the total loans borrowed by the states, the proportion of loans borrowed from the Central Government has occupied the major share in the total loans and this has tended to increase. As a result of it the burden of debt repayment and payment of interest to the Centre has progressively increased.

It has been estimated that interest on loans obtained from the Centre recorded an increase of 386.02 per cent from

Rs. 57.20 crores in 1960-61 to Rs. 278.50 crores[3] in 1970-71. This interest on loans from the Centre which accounted for 8.7 per cent of the own revenue receipts of the states in 1960-61 increased to 14.4 per cent in 1970-71. The average rate of interest on Central loans worked out to Rs. 4.6 per cent in 1970-71 as against 2.8 per cent in 1960-61. Interest charges as a proportion of the States' own revenues went up from 19.5 per cent in 1969-70 to 20.1 per cent in 1973-74 at the end of the Fourth Plan. Interest on loans from the Centre at Rs. 374 crores at the end of the Fourth Plan accounted for 70.4 per cent of the total interest charges.

Since the volume of loans from the Centre has tended to increase, the burden of debt repayment has also increased as indicated by the difference between the gross and net loans from the Centre as shown in Table 6.5.

TABLE 6.5

Loans (*in crores of rupees*)

	Gross	*Net*	*Difference*
Total First Plan Period	719.7	637.9	81.8
Total Second Plan Period	1374.8	1037.9	336.9
Total Third Plan Period*	3101.4	2151.2	950.2
Total Fourth Plan Period	6508.3	2787.5	3720.8

It will be seen that during the Fourth Plan period the difference between the gross and net amount was so large that repayments accounted for 57 per cent of the gross amount. Due to these reasons the States have been pressing for the rationalisation of their loans from the Centre and their adjustments. The question had been examined by the Sixth Finance Commission which recommended the consolidation of numerous central loans of diverse nature into a few specified categories to provide relief on a uniform basis to all states in respect of a large number of categories and discretionary relief in regard to other categories on the basis of certain principles. Block loans to states for State Plans, special accommodation loans, loans for

relief of distress caused by natural calamities, loans for clearing overdrafts and miscellaneous development loans were selected for discretionary treatment. These loans were consolidated as on March 31,1974 to be repaid in periods ranging between 15 to 30 years with a moratorium towards repayment ranging from 2 to 5 years for certain states. But, though these recommendations have given some relief to the states, they have not been able to solve the basic problems of the States' debt position and policy.

The burden of debt repayment and payment of interest charges on Central loans has created enormous problems for the finances of the states because the capital assets and public undertakings built up by the states with the help of such loans have not been yielding any net return. On the other hand, the states have been incurring huge losses on their operation. The overall losses on account of departmental undertakings of the states increased from Rs. 17.1 crores in the first year of the Fourth Plan to Rs. 85.1 crores in 1973-74 at the end of the Fourth Plan. The multipurpose river valley schemes and irrigation (commercial) projects have been showing substantial and increasing losses. The picture in this regard shown in Table 6.6 is highly revealing.

TABLE 6.6

Net Contribution of Departmental Undertakings of States

(in crores of rupees)

Item	*1969-70*	*1970-71*	*1971-72*	*1972-73*	*1973-74*
1. Forests	71.6	71.2	91.6	89.7	85.4
2. Multi-purpose River Valley Schemes	—31.5	—41.1	—49.7	—52.7	—55.6
3. Irrigation (Commercial)	—66.5	—81.7	—91.3	—99.2	—112.7
4. Electricity Schemes	6.4	3.7	0.9	0.8	—0.1
5. Road and Water Transport Schemes	3.1	2.4	2.5	4.7	4.0
6. Industries	—0.5	—2.6	—3.7	—1.2	—0.6
Net contribution of Departmental undertakings.	—17.1	—51.8	—54.4	—64.4	—85.1

Therefore an improvement in the finances of the states is closely bound up with an improvement in the financial performance of the public undertakings in the states sector. While the process of planned economic development has widened the size of the public sector enormously, the investments made in this sector especially in the sphere of the state governments have not been yielding a positive rate of return in most cases. Thus the problems of the States' finances is a multi-dimensional one and it is difficult to suggest a cut and dried solution.

The Fifth Plan Period

During the Fifth Plan there was further deterioration in the finances of the states as indicated by the larger gap between their own resources as shown in Table 6.7.

TABLE 6.7

(in crores of rupees)

	1974-75	*1975-76*	*1976-77*	*1977-78*
Own tax revenues of States	2363.13	3546.20	3963.90	4384.00
Own non-tax revenues of States	1220.16	1574 37	1819.48	1972.86
Total own revenues	3584 29	5120.57	5783.38	6366.86
Total revenues	5858.74	7938.16	8935.42	9754.26
Total gap in revenues	2274.45	2817.59	3152.04	3397.40

Thus the gap in their own resources and total resources of the states on revenue account has tended to widen and it was filled up by revenues derived from shared taxes and Central grants. If we take into account the total expenditures of the states on revenue account and their own resources the gap between the two was as indicated in Table 6.8 showing an increasing deficit and worsening resource position.

TABLE 6.8

(in crores of rupees)

	1974 75	*1975-76*	*1976-77*	*1977-78*
Total expenditures (on revenue account)	5827.30	6966.50	8167.21	9014.08
Total own resources	3584.29	5120.57	5783.38	6356 86
Difference	2243.01	1845 93	2383.83	2657.22

This is the picture of the state finances only on their revenue account. If, however, one takes into account the total picture on both revenue and capital accounts, the gap in the states resources was much larger. During the Fifth Plan, the dependence of the states on Central resources was further increased in view of the large rise in their plan and non-plan expenditures and the failure of their own resources to respond adequately to their growing needs (See Table 6.9).

TABLE 6.9

Transfer of Resources from the Centre during the Fifth Plan

(in crores of rupees)

	1974-75	*1975-76*	*1976-77*	*1977-78*
Shared taxes	1196	1599 12	1654.89	1794.07
Plan Grants	1078	1218.50	1497.12	1669.81
Non-Plan Grants		616.30	804.07	718.49
Plan loans	1034	798.40	862.26	950.16
Non-Plan loans		495.90	512.77	510.60
Total	3308	5028.23	5341.11	5643.13

The larger transfer of resources from 1975-76 onwards reflects partly the impact of the Sixth Finance Commission on the finances of the states. Since a significant portion of the resources transferred was in the form of loans, it involved a burden on the states' finances. The following were the figures of repayments of loans and payments of interest on Central loans by the states which indicate the burden on the states' resources; (See Table 6.10).

TABLE 6.10

(in crores of rupees)

	1975-76	*1976-77*	*1977-78*
Loan Repayments to the Centre	761.7	688.3	621 0
Interest on loans from the Centre	445.71	486.78	513.83

This had the effect of reducing the net transfer of resources to the states from the Centre. The net transfer[2] of resources

from the Centre to the states doing this period, therefore, was Rs. 1305 crores (1975-76), Rs. 1814 crores (1976-77) and Rs. 1996 (1977-78).

The question of the states' indebtedness to the Centre was further examined by the Seventh Finance Commission which recommended substantial relief and this has been examined in Chapter 10 in full details.

References

1. Singh, Tarlok, "Administrative Relations in Planning" *The Indian Journal of Public Administration*, April-June 1955, p. 144.
2. Net transfer means grants and loans—repayment of loans from the Centre and interest payment on loans from the Centre.

7

INTER-STATE DISPARITIES IN THE RATE OF ECONOMIC DEVELOPMENT

The measurement of inter state disparities in the rate of economic development would logically involve the calculation of per capita real income in each state as well as the estimate of the rate of capital formation in each state. But due to the lack of the necessary statistical data relating to national income and capital formation in each state, it is not possible to indicate in exact statistical terms the quantitative magnitudes of the existence of inter state disparities in the rate of economic development in India.

Dr. B. Natarajan, for the first time, attempted to make an estimate of the national income and of per capita income for each of the *Part A States* for the year 1949-50.[1] His estimate has revealed the existence of wide disparities in per capita income and so in the rate of economic development.

But these estimates cannot be considered as reliable. Their unreliability springs from a number of factors. In the first place, they were based upon the estimates of national income for 1931 32 by Dr. V.K V. Rao,[2] which were themselves based upon inadequate data. Secondly, they were drawn from Dr. Rao's estimate through ratios arbitrarily chosen and applied. National income figures for 1938-39 and 1948-49 were found out by raising Dr. Rao's figures for 1931-32 with reference to the increase in the index number of wholesale prices with 1931-32 as the base, weighting them for increase in production during these periods Estimates of income for different states were worked out by ratios for each state compared to India as a whole under each of the three categories of income—agriculture, industry, and tertiary. The ratio adopted for agriculture was based upon the criteria of (*a*) cultivated area, (*b*) population occupied in the exploitation of the surface of the earth,

(*c*) total yield of the principal crops and (*d*) livestock population. The unreliability of these estimates is amply borne out by the fact that according to these estimates per capita income for the Indian Union was computed at Rs. 228 for the year 1949-50 at current prices, whereas the National Income Committee has computed the per capita income for the same year at Rs. 253.9 at current prices."[3]

The National Council of Applied Economic Research had estimated the per capita income of the states for 1960-61.[4] Luis Lefeber[5] estimated the per capita income of states for the year 1964-65. The census of 1971 also estimated the per capita income of states for 1971. If in terms of the per capita incomes of states for 1950-51, these figures of state per income be compared, the following picture of disparities in per capita income levels in the different states would appear as shown in Table 7.1.

The figures are highly revealing. They not only indicate the existence of wide disparities in income levels and levels of living in the different states but also that they have been growing at very different rates. In 1950-51 West Bengal had the highest per capita income, but it sank to the second position in 1960-61 and to the fourth place in 1964-65 in rank. Punjab has had the highest rate of growth because it rose from the second position in 1950-51 to the first position in 1964-65 while Maharashtra has risen from the fourth position in 1950-51 to the first position in 1960-61 but sank to the second position in 1964-65. Assam which occupied the 5th rank in 1950-51 sank to eighth in 1964-65 indicating a slow rate of growth of its economy while Bihar continued to be at the fourteenth rank throughout. This, therefore, means that regional disparities had increased in this country despite three decades of planned development. If these figures be compared with those of 1971 a number of significant trends emerge. Firstly, the regional disparities have further widened. For example in 1950-51 the difference between the lowest per capita income (of Bihar) and the highest per capita income (West Bengal) was in the ratio of approximately 2:5, but this difference was of a larger magnitude in 1971. In 1971 the difference between per capita income of Orissa (Rs. 325.0) and that of Punjab (Rs. 945) become approximately 1:3. Secondly, West-Bengal with the highest per capita income in

1950-51 sank to the ninth place in 1971 in course of twenty years while Punjab with the second rank in 1950-51 rose to the first rank in 1971. Thirdly, the rates of growth of the different

TABLE 7.1

State	Per capita income (in Rs.) 1950-51	Rank	Per capita income (in Rs.) 1960-61	Rank	Per capita income (in Rs.) 1964-65	Rank	Per-capita income (in Rs) 1971	Rank
1	2	3	4	5	6	7	8	9
Andhra Pradesh	257.5	9	287	10	458	5	545	7
Assam	334.6	5	333	6	394	8	545	7
Bihar	180.6	14	221	14	292	14	402	15
Gujarat	381.0	3	395	4	423	3	657	4
Haryana	—	—	—	—	—	—	788	2
Himachal Pradesh	—	—	—	—	—	—	563	5
Kerala	303.9	6	315	7	391	9	526	8
Madhya Pradesh	235.8	13	285	11	378	10	554	6
Tamil Nadu	244.7	12	384	5	436	7	644	5
Maharashtra	373.3	4	469	1	529	2	778	3
Manipur	—	—	—	—	—	—	476	13
Karnataka	286.8	7	305	8	441	6	532	8
Orissa	251.8	11	276	12	368	12	325	16
Punjab	404.4	2	451	3	619	1	945	1
Rajastan	257.3	10	267	13	365	13	488	12
Tripura	—	—	—	—	—	—	459	14
Uttar Pradesh	270.0	8	297	9	374	11	504	11
West Bengal	471.4	1	465	2	495	4	524	9
Jammu & Kashmir	—	—	289	10	—	—	513	10
All India	295.8		335		421.5			

(Figures for 1971 taken from Census of 1971)

states have been very uneven, while the Punjab and Maharashtra have achieved the highest rate of growth as a result of which their per capita income more than doubled in this period, the rate of growth in Orissa has been the lowest and the growth

rate of its per capita in the period was only about 33 per cent in twenty years or 115 per cent per year.

This means that the process of planned economic development in India, instead of achieving a balanced regional development, has accentuated the inter-regional disparities in development levels and levels of living.

Factors leading to Inter-State Disparities in Development

Inter-state disparities in the rate of development in a country like India with a continental geographical dimension would result from an uneven distribution of productive resources, different levels of the utilisation of the potential resources, differences in the level of development of private enterprise and from a large number of non-economic factors, such as differences in attitudes as well as uneven geographical and climatic conditions. In the context of the present study, it is neither possible nor relevant to go into an examination of all these factors.

In a country where the public sector plays a very important part in accelerating the rate of economic development, inter-state disparities in the rate of development, (unless made up for by the compensatory development efforts of private enterprise) would emerge as a result of the uneven impact of the development plan of the public sector on the different states. In a federal structure of public finance, the development plan of the public sector tends to be divided into two sub-sectors, (*a*) the plan of the Centre and (*b*) the plan of the states. Thus every region in the country tends to receive the impact of the development efforts of the plan of the Centre and of a particular state.

Assuming that the Central plan of development is geared to the objective of raising the level of development in each state at the same rate, disparities in the rate of development in the different states would exist and might tend to widen because of the varying impact of the development plans of the different states. If the development plan of the Centre has varying impacts on the rate of development in different states, it might make up for, or exaggerate the varying impacts of the

state plans on the rate of development of the different regions.

Inter-regional disparities in per capita incomes are a function of a number of factors. In the first place they can be explained in terms of the economic sector thesis propounded by Colin Clark. This thesis has maintained that "Low real income per head is always associated with a low proportion of the working population engaged in tertiary production and a high percentage in primary production. . . . A high average level of real income per head is always associated with a high proportion of the working population in tertiary industries."[6] This thesis is essentially based on the assumption that at high income per capita there is a greater demand for tertiary products. This is because the income elasticity of demand for tertiary goods is higher than that for the goods of primary and secondary sectors, and the demand for tertiary products increases relatively more rapidly with economic progress. Thus the proportion of occupied labour force in tertiary production rises with economic progress. The thesis, therefore, is descriptive of the process of economic growth and differences in the state income levels in relation to industrial structure, productivity and the pattern of demand. In case of India it is found that in the states with higher per capita income a larger percentage of the working force is engaged in secondary and tertiary production and a lower percentage of the population is engaged in primary production. This is associated further with a higher productivity of labour in tertiary and secondary industries as compared with that in primary production.

Secondly, the locational pattern of industrial development in India till the pre-plan period was very much influenced by the early pattern of railway construction and railway freight-rate policy which were not guided by considerations of the potentialities of industrial development in different parts of the country. These centres of industrial location, therefore, have attracted a considerable portion of industrialisation towards themselves because of conglomeration economies. Thus the Indian experience has been in comformity with Gunnar Myrdal's thesis that "within broader limits, the attractive power today of a Centre of industrial and commercial expansion has a main origin in the historical accident and thereafter the ever increasing internal and external economies which sustained

their continuous growth".

Thirdly, it has also been found that as the development of the economy has progressed, the positive relationship between prosperity and the importance of the manufacturing sector has become more clear and strong. Levels of income have been strongly associated with the rate of increase in manufacturing output. This means that the process of industrialisation has proceeded at different rates in different states leading to magnify inter-regional imbalances. Further, the introduction of the new technology into the agricultural sector has augmented regional economic disparities. The propagation of the new technology in agricultural development has consisted in the use of high yielding varieties of seeds, fertilisers, irrigation, pesticides and farm machinery. The different states of the country have not been evenly benefited by the new technology of farm development because of differences in several factors such as regional differences in the size of holdings, tenure systems, technological and management factors, sociological factors and in infrastructural development such as electricity and transport and in natural resources like water which is a crucial determinant of the successful use of the new farm technology. Thus imbalances in regional development have occurred and magnified due to different rates of agricultural growth in different states due to the fact that there have been differences in the use of new technology and the factors making for the successful use of the new technology of farm development.

Besides, the operation of the term-lending institutions such as the Industrial Finance Corporation, the Industrial Development Bank, the Industrial Credit and Investment Corporation has benefited Maharashtra, West Bengal, Tamil Nadu and Gujarat to a very large extent. In the same way the operation of the commercial banking system has been leading to a larger concentration of bank finance in the highly developed states. Thus there has been a distinct tendency towards a concentration of investments in the relatively more developed states.

Last but not least, the operation of the system of public finance in the country has also contributed to the creation and aggravation of inter-state disparities. In a federal system of public finance there have operated in this country, two fiscal systems simultaneously on each state modifying the

flow of resources from one state to another, affecting differently the rates of saving and investment and so the rates of growth in each state. In the low income states, the per capita revenues and per capita expenditures of the government are smaller as compared to those in the high income states. Thus in the low income states, the level of public investment, infrastructural growth and standard of administrative services are lower as compared to those in the high income states. Thus in the high income states the process of what Myrdal calls, cumulative causation tends to operate leading to a self-sustaining growth while the low income states are caught in the stationary equilibrium of underdevelopment; their growth rates being retarded by the 'backwash' effect. This condition of unevenness in growth rates and imbalances in development levels, however, can be corrected if the Federal Government, through its allocation of resources among the different states seeks to make up for the differences in resources and levels of public expenditure and investments between the different states.

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In India, however, the uneveness in the levels of resources of the different states and their expenditures and investments has not been corrected through the central allocation of resources among the states so far. This can be indicated in terms of the trends in the per capita revenue and per capita expenditure of the states over the period of the five year plans. The Reserve Bank of India made a study of the trends in per capita expenditure of the state over the period 1951-52 to 1965-66, the period of the three Five Year-Plans and the study revealed a number of significant trends in this regard as shown in the Table 7.2.

It is found that at the beginning of the period under study the level of per capita expenditure was the highest in Mysore (Now Karnataka) at Rs. 19.0 followed by the erstwhile Bombay state (Rs. 15.7), West Bengal (Rs. 14.2) and Kerala (Rs. 14.1). It was the lowest in Orissa at Rs. 7.4. During the 15 years of the plan period the average per capita expenditure level for all the states increased more than threefold from Rs. 11.6 in 1951-52 to Rs. 38.7 in 1965-66. The rate of increase was marked

TABLE 7.2

Trends in Per Capita Expenditure—Current Prices

(In Rupees)

	1951-52					*1965-66*				
	Development					*Development*				
	Human capital	*Physical capital*	*Total development*	*Non-development*	*Total expenditure*	*Human capital*	*Physical capital*	*Total development*	*Non-development*	*Total expenditure*
Andhra Pradesh	2.8	3.2	6.0	6.1	12.1	11.4	15.0	26 4	14.2	40 7
Assam	2.9	3.5	6.4	6.0	12.4	12.6	18 6	31.3	18.7	49 9
Bihar	1.4	3.1	4.5	4.0	8.5	5.9	7.0	12.9	9.1	22.0
Bombay	3.8	3.8	7.6	8.1	15.7	12.1	13.7	25.8	23.8	49 6
Kerala	3.7	3.5	7.2	6.9	14.1	20.2	10 5	30 7	12 8	43.5
Madhya Pradesh	1.9	2.3	4.2	4.5	8.7	11.3	9 1	20.4	12.2	32.6
Madras	2.8	3.5	6.3	4.7	11.0	14.2	18.9	28.1	17 4	45.5
Mysore	4.3	6.8	11.1	7.9	19.0	13.0	14.2	27.2	15.0	42.2
Orissa	1.4	2.8	4.2	3.2	7.4	9.4	18.6	28.0	18.5	46 5
Punjab	2.2	2.9	5.1	7.8	12.9	12.7	16.5	29.2	22.9	52.1
Rajasthan	2.3	1.7	4.0	5.8	9.8	12.2	10.0	22.2	15.8	38 0
Uttar Pradesh	1.7	2.4	4.1	4.7	8.8	7.8	8.4	16.2	12.5	28.7
West Bengal	2.9	3.4	6.3	7.9	14.2	11.0	12·4	23.4	18.8	42.2
All States	2.6	3.2	5.8	5.8	11.6	11.0	11.9	22.9	16.0	38.9

in states like Orissa (sixfold) and Assam, Madras, Punjab and Rajastan (fourfold). A small increase however, (about 205 times) was observed in Bihar and Mysore. As a result, the inter-state per capita expenditure levels underwent significant changes over the period. For instance, in 1965-66 Assam, Orissa and Punjab ranked second, fourth, and first respectively in the level of per capita expenditure as against sixth, thirteenth and fifth respectively in 1951-52. Mysore which was first and West Bengal third in 1951-52 went down the list to the seventh and eighth position respectively.

However, as the development expenditures of the states particularly those on physical capital have a direct bearing on the rates of economic growth, it is found that the per capita development expenditure of Punjab increased about sixfold, that of Bihar increased only threefold and of Orissa a little less than sevenfold. The level of per capita expenditure and development of human capital was the highest at Rs. 4.3 in Mysore followed by Bombay at Rs. 3.8 and Kerala Rs. 3.7, it was the lowest at Rs. 1.4 in Bihar and Orissa. During this period the per capita expenditure on this item increased three and seven times. The lowest increase being in Bombay and the highest in Orissa. As a result, states such as Bombay and West Bengal which ranked second and fourth respectively in 1951-52 in regard to the level of expenditure on development of human capital went down to the seventh and tenth places respectively in 1965-66.

As regards physical capital, the data shows that the per capita expenditure on this item was the highest at Rs. 6.8 in Mysore and lowest Rs. 1.7 in Rajasthan in 1951-52. Over the period, this expenditure increased between two times in the case of Mysore to six and a half times in Orissa, the highest per capita expenditure at Rs 18.6 being in Orissa and Assam and the lowest of Rs. 6.9 in Bihar. As a result Mysore which stood first in the level of per capita expenditure in 1951-52 lost its place in 1965-66 to Orissa and Assam which stood tenth and third respectively in 1951-52. Similarly Punjab which was ninth went up to the third position over the period.

The data also indicates that there was a shift in favour of development expenditure in all the states, but it was greater in states like Punjab. If we correlate the rate of growth of per capita development expenditure to the rate of growth of per

capita income significant results follow. As the per capita development expenditure of Punjab recorded the highest rate of increase, it led to the highest increase in per capita income of the state with the result that in 1971 the state had the highest per capita income. States like Orissa recorded a significant increase in per capita development expenditure, but still the per capita income of the state was the lowest in 1971. This means that increase in per capita expenditure of the state was not enough to lead to a marked increase in the rate of economic growth so as to make up the deficiency in per capita income. In the case of Bihar the increase in per capita development expenditure, was much below that of the average development expenditure of all the states and therefore, the rate of growth in per capita income of the state was quite inadequate to enable the state to catch up the fast growing States in the race for economic development.

The data also reveals a positive and high correlation coefficient between the rate of growth of per capita development expenditure and rate of growth of per capita income but the acceleration in the rate of growth of per capita expenditure in the low-income states was not enough to bridge the gap in the per capita incomes of the states. We also find that there were significant differences in per capita development expenditures of the states in 1965 66, i.e., at the end of the Third Plan. Assam had the highest per capita development expenditure followed by Kerala a close second, and Punjab and Bihar had the lowest per capita development expenditure in 1965-66 which was nearly half of the all-India average.

Thus the operation of the system of public finance in the country had much today with the emergence of disparities in the levels of development of the different states and this has not contributed to the narrowing of these disparities since the differences in the per capita development expenditure between the more developed and less developed states were as wide in 1965-66 as in 1951-52. In 1951-52 the ratio between the per capita development expenditure of Bihar and Bombay was 4 : 7 and in 1965-66 it was 1 : 2, i.e., greater than in 1951-52. In case of Orissa, however, it is found that the ratio between the per capita development expenditure of this state to that of Madras was 2 : 3 in 1951-52, and it stood at 1 : 1 in 1965-66 but still the

difference in per capita income of the two states became greater indicating that the erstwhile state of Bombay had a faster rate of economic development than that of Orissa. Thus the states with an earlier advantageous position in economic development have kept it up and that apart from the system of public finances other factors have also contributed to the higher rates of growth in the more developed states such as the conglomeration economies, infrastructural development and the role of dynamic entrepreneurship in the industrial and commercial sectors.

If we extend the analysis to cover the period of the Fourth Plan, the following picture as shown in Table 7.3 emerges with regard to the growth of per capita expenditure of the states.

TABLE 7.3

Growth in per capita Development Expendiure

(in Rupees)

State	*1951-52 Development*	*1971-72 Development*
Andhra Pradesh	6.0	36.0
Assam	6.4	55.8
Bihar	4.5	25.0
Gujarat	7.6	45.0
Haryana	5.1	50.6
Himachal Pradesh	—	111.4
Jammu and Kashmir	—	67.8
Kerala	7.2	58.0
Madhya Pradesh	4.2	33.0
Maharashtra	7.6	45.4
Tamil Nadu	6.3	50.1
Karnataka	11.1	51.1
Orissa	4 2	40.7
Punjab	5.1	59.0
Rajasthan	4.0	40.9
Uttar Pradesh	4.1	28.3
West Bengal	6.3	38.5

(Estimated on the basis of the population of States in 1971)

It will be seen from the above Table that per capita development expenditure increased about 12 times in Punjab with the result that this state had the highest rate of growth in per capita income. Next comes Haryana with 10 times growth in

per capita development expenditure and with per capita income next only to Punjab in 1971. Orissa had more than ninefold increase in per capita development expenditure but had the lowest per capita income in 1971. Bihar had the lowest rate of increase in per capita development expenditure, thus accounting for the slow rate of growth in the per capita income of the state. In Uttar Pradesh the per capita development expenditure increased by sevenfold but still the per capita income did not catch up with that of Maharashtra, Haryana, and Punjab. The gap between the per capita income of Uttar Pradesh, Bihar and Orissa on the one hand and that of Punjab on the other widened in the period.

The growth of development expenditure of the different states during the plan period has not been of a magnitude so as to produce an adequately equalising effect on their per capita income and level of growth. This would have involved a considerable stepping up of the development expenditure under the plans of the low-income states. But this did not take place. It seems the Planning Commission was guided by the objective of maximisation of the rate of growth in the economy as a whole and, therefore, the resources tended to be concentrated at high growth Centres which lay in to high income States. Secondly the low-income states had administrative constraint in stepping up their development outlays apart from resources constraints. A larger development outlay involves organisational and administrative framework to implement it successfully and the low income states did not possess such a framework. This is indicated by the fact that most of the low income States had a large shortfall in their plan outlays and their financial performance was below the plan targets. This had the effect of slowing down their growth rates. Besides, it is not only the amount of financial outlay that is important in determining the rate of growth but also its effectiveness and the results achieved in terms of output growth. The low-income states have been operating under tremendous handicaps in this regard. Table 7.4 indicates the growth in the development outlay of each state over the period 1951-52 to 1977-78, i.e., from the beginning of the First Plan to the last year of the Fifth Plan.

The figures indicate that the rates of growth of the development expenditures of the states have shown very large

disparities. While the development expenditure of Punjab (including Haryana) increased about 70-fold in the period of 26 years, that of Bihar increased by 25-fold only. Karnataka's development expenditure also increased by 24-fold as a result of

TABLE 7.4

State	1951-52	1965-66	1977-78
Andhra Pradesh	18.78	96.90	713.85
Assam	5.65	50.92	180.77
Bihar	17.61	65.14	450.06
Gujarat (included in Maharashtra)		62.68	430.19
Haryana (included in Punjab)		10.55	236.00
Himachal	———	———	98.32
Jammu and Kasmir	———	16.53	173.65
Karnataka	21.48	68.14	509.29
Kerala	9.76	56.37	383.58
Madhya Pradesh	11.07	72.38	554.10
Maharashtra (including Gujarat)	36.86	126 91	930.92
Manipur	———	———	43.97
Meghalaya	———	———	33.90
Nagaland	———	———	42.50
Orissa	6.06	50.99	315.17
Punjab (including Haryana)	8.29	65.94	309.51
Rajasthan	6.37	54.10	413.52
Tamil Nadu	19.05	109.01	499.85
Uttar Pradesh	26.09	119.91	929.43
West Bengal	16.65	90.52	576.54

which the state went down in the level of development. The development expenditure of Maharashtra (including Gujarat) increased 40 times with the result that both Maharashtra and Gujarat have kept up their levels of development and per capita income. The development expenditure of Uttar Pradesh increased by 44 times over the period with the result that the state forged ahead but could not catch the fast-growing states like Punjab and Haryana. The development expenditure of Assam

increased 32 times but this increase was not enough to enable the state to make up its deficiency in growth rate and per capita income. The development expenditure of West Bengal increased only 22 times resulting in slowing down its growth rate and reducing the rank of the State in per capita income. The development expenditure of Orissa, however, was stepped up by 52 times representing the second largest increase in the rate of development expenditure after Punjab and Haryana but the state still lagged behind in per capita income and the level of development.

The analysis, therefore, shows that development expenditure of the low income states was not adequately stepped up to make up the deficiency in per capita incomes and levels of development. While the development expenditures of the high income states increased at a faster rate as compared to the low income ones, the disparities in levels of development and per capita income were magnified. But some of the high-income states such as West Bengal failed to step up their development expenditure to an extent adequate to keep them in the category of fast-growing states. Thus, there does not appear that a conscious and adequate attempt was made to bring about an inter-regional balance in economic growth by correcting the inter-regional disparities in levels of develpment. These uneven rates of growth in development expenditures reflect the uneven availability of resources available to the different states.

In the second year of the Third Plan the per capita resources available to the different States were as in Table 7.5.

TABLE 7.5

(in rupees)

State	*(1962-63) Per Capita State Taxes*	*Per Capita grant from the Centre*	*Per Capita Tax revenues*	*Total*
1	2	3	4	5
Andhra Pradesh	13.4	5.8	17.9	23.70
Assam	12.1	14.5	17.8	32.30
Bihar	7.6	3.8	11.8	15.60
Gujarat	12.1	6.1	18.4	24.50
Jammu and Kashmir	8.5	16.8	20.2	37.00

1	2	3	4	5
Kerala	15.2	8.2	20.2	28.4
Madhya Pradesh	10.3	5.1	14.7	19.8
Tamil Nadu	15.6	4.1	20.3	24.4
Maharashtra	16.9	3.9	20.1	24.0
Karnataka	12.2	7.8	26.7	34 5
Orissa	7.4	12.4	12.9	25.3
Punjab	14.0	5.4	19.6	25.3
Rajasthan	12.0	6.2	16.6	22.8
Uttar Pradesh	8.2	3.8	12.0	15.8
West Bengal	15.1	5.7	16.7	22.4

The figures indicate wide disparities in the resources available to the states. While Bihar and Orissa had per capita tax revenues amounting to Rs. 11.8 and Rs. 12.4 per capita, these are the two states with lowest per capita income but the grants to Bihar per capita were much lower as compared to those of Orissa. In the same way, Uttar Pradesh is one of the low-income states but the Central grants per capita to Uttar Pradesh were just equal to those of Bihar and less than those of Punjab, Gujarat and West Bengal. Thus the Central grants to states do not appear to have been guided by the objective of filling up the gaps of unevenness in the resources of the states. The gaps in the resources of the states persist still and they appear to have widened as indicated in Table 7.6.

The following figures indicate that there have been wide differences in the per capita own tax revenues of the states ranging from Rs. 1.2 per capita in case of Tripura to Rs. 68.4 per capita in case of the Punjab. These differences reflect the results of the tax efforts made by the different states to raise resources as well as differences in the taxable resources and potentials of the different states which are the products of their levels of economic development. If we take into account the amount of shared taxes allocated to the different states under the recommendation of the Finance Commission, it is found that differences in per capita tax revenues of the different states have persisted as compared to the figures for 1962-63. West Bengal's figures for per capita grant for the year 1971-72 were high, largely because of financial assistance from the Centre on account of Bangladesh refugees. If this amount be reduced

from the total Central grants to the state, the figures would be much less.

The per capita grants to States have ranged from Rs. 7.20

TABLE 7.6

State	*Per capita own tax revenues*	*Per capita tax revenues*	*Per capita grants from Centre*	*Total*
Andhra Pradesh	31.8	48.00	12.5	60.50
Assam	22.3	37.50	37.5	75.00
Bihar	15.5	34.00	7.20	41.20
Gujarat	47.0	64.50	10.0	74.50
Haryana	51.5	64.80	12.17	76.97
Himachal	24.0	43.00	75.30	118.30
Jammu & Kashmir	17.0	37.00	80.90	117.90
Karnataka	39.0	55.00	9.50	64.50
Kerala	33.5	52.00	13.25	65.25
M.P.	22.7	39.00	9 50	48.50
Maharashtra	54.5	74.50	9.00	83.50
Manipur	7.1	8.60	103.30	111.90
Meghalaya	2.4	20.60	258.20	278.80
Nagaland	10.2	26.40	520.20	546.60
Orissa	15.8	33.00	20.20	53.20
Punjab	68.4	85.30	15.40	100.70
Rajasthan	25.6	42.30	16.40	58 70
Tamil Nadu	46.6	64.00	8.90	72.90
Tripura	1.2	4.00	100.90	104.90
Uttar Pradesh	17.7	35.50	7.20	42.70
West Bengal	32.7	50.40	38.50	88.90

These figures are for 1971-72.

in case of Bihar and Uttar Pradesh to Rs. 520.20 in case of Nagaland in which the Central grants have been the main source of the finances of the state. In the same way in case of Himachal Pradesh, Jammu & Kashmir, Manipur, Meghalaya and Tripura the Central grants have been disproportionately large and have constituted the mainstay of the finances of these States. These are newly created States with very underdeveloped economies and the Central grants to them have been directed to give a boost to their economies and put them on the path of cumulative growth in order that they come at par with other states. Thus the Central grants have contained strong elements

of equalisation. But at the same time the per capita grants to the comparatively low income states of Bihar and Uttar Pradesh have been the lowest which seems to be a perverse element in the structure of Central grants. As a result the per capita revenue of these states have been the lowest leading to lower levels of growth and per capita income in them. Punjab and Haryana have some of the highest per capita revenues as a result of which they have been in the forefront of the race for economic development.

It is not suggested in this study that the Central grants to the high-income states should have been so reduced as to slow down their growth rates to bring their per capita incomes at par with those of the low-income ones. This would have the effect of slowing down the rate of growth of the economy of the country as a whole. The contention of this study is that the low income states should have been allocated more resources to impart a greater element of dynamism in their economies.

Thus, it can be concluded that the operation of the system of public finance in the country has not been sufficiently directed to the achievement of the objective of inter-regional resource equalisation and balance in economic development.

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8

ALLOCATION OF RESOURCES AMONG STATES THROUGH SHARED TAXES

One of the important media of the transference of resources from the Centre to the states has been the allocation of the proceeds from taxes shared between the Centre and the states. Allocation of the proceeds from income tax among states was begun before the war in terms of the Niemeyer Award according to which 50 per cent of the proceeds was distributed among the States.

The main consideration that guided this scheme of allocation of resources among individual states was to achieve "financial equilibrium,"[1] in the static sense and to end "the chronic state of deficit into which some of the states had fallen in the wake of the depression."[2]

The Partition of the country in 1947 necessitated a readjustment of the scheme of allocation of income tax. But the basis of the re-allocation of income tax as determined by the Distribution of Revenues Order of March 1948, passed by the Government of India, did not undertake a revision of the Niemeyer Award in accordance with the criterion of correcting the inter-state disparities in resources. The essential character of the new arrangement was to determine the share released by the partitioned states on the basis of the Niemeyer formula. The share thus determined was pooled and redistributed among the states of the Indian Union according to their population; it being an addition to the basic Niemeyer percentage with a readjustment in favour of Assam just for the sake of rounding off of figures. As the basis of redistribution was fundamentally within the framework of the Niemeyer Award, it did not result in tilting the scales in favour of the poorer States and inter-State fiscal disparities remained uncorrected.

Pending the setting up of a Finance Commission, as envisag-

ed in the new Constitution, the Government of India appointed Sri C.D. Deshmukh to make an adjustment in the allocation of resources from the divisible pool of income tax among the states. But Deshmukh did not undertake, nor was he expected to, the examination of the entire problem *de novo*. He merely attempted to readjust the basis of allocation within the existing framework which had evolved since the Niemeyer Award. He limited himself to the determination of percentages released as a result of the partition and their allocation among the states in the Indian Union. He attempted to estimate as nearly as possible the percentages that might have been allotted by Sir Otto Niemeyer to part of the states now included in Pakistan, had they been in existence as separate states at that time. The percentages thus determined were distributed by him largely on the basis of population, making minor adjustments for the purpose of rounding off and giving a small weightage in favour of the weaker states.

In taking population as the basis of reallocation of the released percentages, Deshmukh was influenced by the consideration that giving weightage to the factor of collection would impart a still greater differential advantage to the states of Bombay and West Bengal in which the bulk of the collections was raised. But as he did not undertake a fundamental revision of the Niemeyer Award, the problem of inter-state fiscal disparity remained unresolved. The Deshmukh Award gave decided advantage to the states of West Bengal and East Punjab whose shares were increased from 12 and 5 to 13.5 and 5.5 respectively. The shares of Madras, U.P. and Bihar were reduced to make the additional percentage available to the divided states, whereas the share of Bombay, the most prosperous of all the states, remained intact.

Even from the point of view of population, the allocation made by the Deshmukh Award appears to have been anomalous. The population of West Bengal (including the refugee population) and that of Bombay (excluding the population of the merged states) were very nearly the same and though the collection of West Bengal was 34 per cent as compared with Bombay's 42 per cent of aggregate divisible pool in 1948-49, the share of Bombay was fixed at more than 50 per cent larger (21 per cent, 13.5 per cent) than that of West Bengal.

In so far as the Deshmukh Award emphasised the short-term fiscal needs of the divided states by increasing their shares at the cost of the backward states, it failed to consider the deficiency in the resources of the states of Assam, Bihar and Orissa. A better arrangement would have been to meet the short-term fiscal needs of the divided state by grant-in-aid rather than by the devolution of more resources through increasing their share in the divisible pool of income tax.

The Finance Commission of 1952 raised the share in the net proceeds of income tax to be distributed among the States from 50 per cent to 55 per cent; and in doing so, it tried to strike a compromise between the fiscal needs of the states and the financial stability of the Central Government. In accordance with the recommendation of the Finance Commission, the share of each state in the divisible pool of income tax was fixed in terms of 80 per cent on the basis of population and 20 per cent on the basis of collection. Therefore it differs from the earlier financial settlements in so far as by giving a much greater importance to the factor of population as "a broad measure of need"[3] it emphasised the necessity of reducing the disparity in the resources of the states.

A comparative analysis of the share of the *Part A* states under the different financial settlements, reveals that their share in the divisible pool of income tax, except that of Orissa, was diminished under the recommendation of the Finance Commission, because the number of participants in the divisible pool had increased from 9 to 16 as a result of the federal financial integration of the former princely states. But this was offset, to some extent, by the inclusion in the divisible pool of the proceeds of income tax raised in the former princely states. The divisible pool was also affected by the assignment of 2.75 per cent of the proceeds to *Part C* States, and also by the larger cost of collection resulting from the inclusion of the former Indian states into the scheme of federal finance. But it is significant to note that 83.75 per cent of the allocable proceeds among the states is shared by the *Part A* states and only 16.25 per cent by the *Part B* states.

It is necessary at this stage to assess the extent to which the financial arrangement evolved by the Finance Commission for the distribution of the divisible pool of income tax among the

States tended to remedy the disparity in the resources of the States as compared with the effects exercised by the earlier financial settlements. A comparison of this arrangement with arrangement that was made under the Niemeyer Award reveals that the increase in the importance of the factor of population under the recommendations of the Finance Commission tilted the scales, to some extent, in favour of the backward States. In the Niemeyer settlement, the exact quantitative weightage given to the factors of population and collection in the determination of the share of each State was not published, but it appears that the shares fixed were somewhat arbitrary; the guiding motive being the achievement of budgetary equilibrium in the strict sense, rather than that of the transference of comparatively larger resources to the backward States for raising the rate of their development.

TABLE 8.1

The Basis of the Determination of Share in the Niemeyer Award (An Estimate)

State	*% of population in 1931 Census*	*% of the total collection of States*	*Half of (2)+(3)*	*Niemeyer Formula*
1	*2*	*3*	*4*	*5*
Assam	3.4	1.6	2.5	2
Bihar	15.6	4.6	10.1	10
Orissa	—	—	—	2
Bombay	8.5	33.3	20.9	20
M.P.	6.0	2.0	4.3	5
Madras	17.4	13.5	15.4	15
Punjab	10.3	7.0	8.7	8
Bengal	18.8	27.4	23.1	20
U.P.	18.3	9.0	13.7	15

(*Sou ce*: Estimated from the Census of India, 1931, and All-India Income Reports and Returns by the Central Board of Revenue).

In the Niemeyer Award, if 50 per cent of the share of each state would have been fixed on the basis of population, and 50 per cent on the basis of collection, the share of each state would have been as indicated in column 4 of Table 8.1. But

to have been uniformly applied in the case of all States, because the figures in column 5 diverge from those in column 4; there being no uniform basis for this divergence. As a result, this scheme of allocation of resources among states tended to favour the states of Bombay and Bengal in which the bulk of the collections was raised and which possessed a comparatively larger taxable capacity than the other states, because of their higher level of development. Thus, the reason why the Niemeyer Award tended to magnify the disparity in the resources of the states is to be found in the fact that it ignored the greater fiscal needs of the backward states by designing a scheme of allocation which gave a very large weightage to the factor of collection which must be regarded as a mere accident in the context of a complex economic organisation. The subsequent financial settlements embodied in the Distribution of Revenues Order 1948, and the Deshmukh Award, being largely within the framework of the Niemeyer Settlement, did not contribute to the remedying of the disparity in the resources of the states. This is borne out by a comparative analysis of the figures of per capita revenues derived by the States from income tax.

An analysis of per capita revenue derived by Part A States from income tax in 1955-56 reveals that the per capita allocations to all the States except Bombay and West Bengal have been equalized for all practical purposes. Thus, the recommendation of the Finance Commission makes an important contribution towards the correction of disparities in the resources of the States in this regard. But it still imparts a differential fiscal advantage to the more developed states of Bombay and West Bengal.

But the determination of the share of each state in the allocation of income tax to the extent of 20 per cent on the basis of collections tends not only to impart a differential advantage to the more prosperous states of Bombay and West Bengal, but also to introduce an arbitrary and quantitatively indeterminable element into the scheme evolved by the Finance Commission of 1952. The Finance Commission, while recognising the arbitrary element in its scheme of allocation, appears to have fallen into the mistake of accepting it largely for the sake of evolving a formula of compromise dictated primarily by political considerations.

In the complex and inter dependent economy of the country, the contribution of a particular state to the divisible pool of income tax cannot be established; and, therefore, the collection of income tax in a particular state cannot be accepted as a correct quantitative index of contribution of that state. The States of Bombay and West Bengal account for nearly three-quarters of the collections of income tax in the country and of these collections again about three-quarters are made within the cities of Bombay and Calcutta.[4]

But the factor of collection is a mere accident, and the "bases of income-creation are far more diversified and widely spread over the country than the facts of collection would seem to suggest."[5] As the Expert Committee on the Financial Provisions of the Constitution put it, "Origin or locus of income is no doubt relevant, but in the complex industrial and commercial structure of modern times, where a single point of control often regulates a vast net-work of transactions, where the raw materials come from one place, are processed in another, manufactured in a third, marketed wholesale in a fourth and ultimately sold in retail over a large area, the assignment (on the basis of origin) can only be empirical or arbitrary."[6]

Large-scale enterprises in industry and trade are important contributory sources of income tax in the country.[7] The fiscal and economic policies pursued by the Central Government with regard to the regulation of company operations, the development of the means of transport, tariffs, subsidies, freight rates and control and location of industries have an important bearing on the pattern and development of large-scale enterprises in industry and trade. In these circumstances, the narrow parochial factor of collection cannot be accepted as a basis for determining the contribution of a particular state to the divisible pool of income tax; and as a result, it cannot serve as a satisfactory basis for the allocation of shared revenues among states. As the Finance Commission put it, "since the benefits which result in the growth of enterprises flow from policies pursued on the ground of national interest, there is every reason why national considerations should, in a large measure, influence the sharing of the proceeds of taxes on such enterprises.[8]

There is some substance in the argument of the Finance

Commission that "there is all over the country a core of income, particularly in the range of personal and small business incomes, which could be treated as of local origin". But in view of the difficulty to disentangle these constituents of income from others which emanate from factors operating over the entire economy, it may not be possible to measure them. Even the core of income in range of personal and small business incomes is powerfully influenced by the location of large-scale enterprises and business activities.

Thus, the suggestion of the Finance Commission for treating 20 per cent of the collection of income tax in each state as flowing from incomes of local origin appears to have been entirely arbitrary and is not verifiable through data for each State relating to national income accounts.

Another important feature of the allocation of resources from shared taxes among states under the recommendations of the First Finance Commission was that 40 per cent of the net proceeds on excises levied on tobacco (including cigars, cigarettes, etc.), matches and vegetable products was distributed among the states since 1952-53. The Commission appears to have been quite justified in recommending the sharing of only those excises with the states which possessed a high yield and "a reasonable stability of yield and comparative immunity from flustuations related to changes in customs tariffs,"[10] because such excise alone would be successful in strengthening the financial resources of the States, and would avoid the elements of uncertainty and violent fluctuations from their revenue resources.

The incidence of excise duties may be assumed to fall on consumption, and therefore, per capita consumption of commodities taxed could be regarded as a satisfactory and equitable basis for the distribution of excises among States. But due to the lack of statistics relating to consumption by different States, of commodities on which excises are levied, the Commission was not in a position to recommend per capita consumption as the basis of allocation of the proceeds from excises among the States. As a result, the share of each State in the proceeds from Union excises was fixed in proportion to its population according to the census of 1951.

The basis of the finances of the states was further widened

by the allocation of proceeds from estate duty since 1954 55; an Estate Duty Act having been passed in the last part of the year 1953, levying an estate duty on agricultural and non-agricultural property; and some of the states having authorised the Centre to incorporate the taxation of agricultural property in the measure.

The problems involved in the sharing of this tax are somewhat simpler, because the Centre is not entitled to a share in it. But the question of allocation among states presents equally difficult problems as those involved in the allocation of the divisible pool of income tax.

According to the Constitution, the proceeds of the tax from agricultural property is situated. In the case of non-agricultural property, there may be conflict between the factors of location of property and of the residence of the deceased.

In the absence of the basic data relating to sources and area of collection, and in view of a very limited experience of the working of the Estate Duty Act, it was not found possible to lay down a satisfactory principle of allocation. Therefore, pending the recommendation of the Second Finance Commission, a provisional distribution was worked out by the Central government allocating the proceeds on the same basis as the States' share of income tax. As the collections of the duty have not been very large, distribution on this provisional basis was not expected to make any significant difference to the finances of the individual states.

A comparative analysis of per capita revenues derived by the State from all the shared taxes reveals that among the *Part A* States, Bombay and West Bengal continued to derive a differential advantage as regards the allocation of resources from shared taxes; though this differential advantage over the backward states has tended to be narrowed down to some extent under the scheme of allocation evolved by the Finance Commission and implemented since 1952-53. Among the *Part B* States, Mysore, Saurashtra and Travancore-Cochin, have a differential advantage over the rest because in place of their share from the income tax and excises, they continued to receive revenue gap grants since 1950-51, under the scheme of federal integration embodied in Article 278 of the Constitution.

A comparative analysis of the per capita revenues of states excluding Central grants, reveals that in spite of the increasing importance of the revenues from shared taxes in the finances of the states, there remain wide disparities in per capita resources of the states; the backward states of Bihar, Orissa and Rajasthan having some of the lowest per capita revenues. Therefore, the conclusion may be drawn that the transference of resources to states through the medium of the allocation of proceeds from divisible taxes has not played a significant part, so far, in correcting the disparities in their resources.

The Second Finance Commission

Income Tax

As regards the percentage of the net proceeds from income tax to be assigned to the states, all the states were unanimous in suggesting to the Commission an increase in this regard. Some states desired the inclusion of corporation tax in the divisible pool and some of them suggested the inclusion in the pool of the Central surcharge and the tax on Union emoluments and pensions. With regard to the principles of distribution of the states' share, there was a wide divergence of opinion among the States.

As regards the determination of the share of the net proceeds to be assigned to the states, the Finance Commission maintained that "income tax has ceased to be an expanding source of revenue it once was. While in future with the progressive expansion of economic activity and plugging of tax evasion, there may be some improvement in the yield, it is unlikely that there will be any very large increase in the revenue from this tax. It is obvious that in the changing pattern of Union taxation, income tax cannot be a major factor in the devolution of further revenues to the States."[11] But in view of the unanimous desire of the states, the Commission felt that some increase in the states' share of this tax was justified, and therefore, after a careful review of the matter in all its aspects, it recommended that the percentage of the net proceeds assigned to the States should be raised from 55 to 60. The Commission expressed its inability to consider the suggestions of the

States for the inclusion of corporation tax, the tax on Union emoluments and the surcharge of income tax levied for the purposes of the Union in the divisible pool as they were against the provisions of the Constitution.

The Commission considered *de novo* all the claims put forward by the states for the distribution of their share in the divisible pool of income tax. It found itself in substantial agreement with the views of the first Finance Commission that such considerations as the proportion of the scheduled castes and tribes and backward classes in the population, the area of the state, its backwardness, etc., are not relevant to a scheme for the distribution of a tax. It also agreed with the opinion of the first Finance Commission, for the reasons given by it, that there is no legal basis for the claim of West Bengal that the Union is in some way required to return to the states the income tax attributable to them after retaining its share.

The Commission considered the two principles, namely population and collection, on the basis of which the States' share in the divisible pool was distributed in accordance with the recommendations of the first Finance Commission. The principle of population found the widest measure of support among the states, while collection was urged, in the main by the two industrially advanced states of Bombay and West Bengal. In all previous schemes of distribution, some weight was given to the factor of collection but this was progressively reduced in favour of population and in the opinion of the Commission this was a move in the right direction. As the *Report of the Second Finance Commission* puts it, "Twenty years ago when income tax first came to be distributed, it could have been argued that the agricultural States had a substantial income from and an expanding source in, land revenue, which had to be balanced by giving a large share of income tax to the industrial and commercial states. Land revenue has now become a comparatively less important source in all states. The growth of revenue from sales taxes, motor vehicles tax and other taxes like electricity duties and entertainment and passenger taxes to which the urban population makes a proportionately larger contribution, has created a situation in which the states, which are more urbanised and industrially developed, are in a financially stronger position than those which are not so well

developed or urbanised. The main justification for giving a large share of income tax to the industrial states has, therefore, ceased to exist. Considering that, in this country, income tax is paid by an infinitesimal portion of the population and the bulk of the tax arises out of business incomes which, in the context of the economic integration of the country and the disappearance of barriers to inter-state trade, is derived from the country as a whole, the principle of collection can no longer be considered an equitable basis of distribution. While, as pointed out by our predecessors, there may be a case for weightage being given to collection in the restricted field of personal income tax, we have come to the conclusion that, taking all factors into account, collection should be completely abandoned in favour of population as the basis of distribution. This may result in a loss to a few States where collections are concentrated and their revenue position should be safeguarded by taking it into account in the overall devolution. As, however, we do not desire to cause a sudden break in the continuity, we propose that the distribution of the states' share should be 10 per cent on the basis of collection and 90 per cent on the basis of population. This should make it easy to complete, in due course the process of eliminating the factor of collection altogether and distributing the entire amount of the States' share on the basis of population."[12]

The Commission adopted the population figures of the 1951 Census as the only practical basis for determining the share of each state in the divisible pool to the extent to which population was regarded as a factor in distribution, and taking the factors of collection and population, the share of each state was expressed as fixed percentage. The Commission further recommended that one per cent of the net proceeds of the income tax be prescribed as attributable to Union territories; and sixty per cent of the net proceeds in any financial year of taxes on income other than agricultural income, except in so far as these proceeds represent proceeds attributable to Union territories or to taxes payable in respect of Union emoluments, be assigned to the states.

As a result of greater importance being given to the factor of population in the determination of the share of each State in the divisible pool of income tax, the scales have been tilted

further in favour of the backward States and as a result, the disparity in the resources of the States has been still further reduced.

Union Excises

As regards the division of the Union Excises, the second Finance Commission was of the opinion that when taxes on income have ceased to be an expanding source of revenue, any further substantial devolution of revenues to the States by sharing of taxes would have to come from Union excises. The coverage and yield of these duties have expanded considerably in recent years. While in 1952-53, excise duties were levied on thirteen commodities giving a net yield of Rs. 83.03 crores, the number of commodities rose to twenty-nine with a total net yield of Rs. 259.057 crores in the budget of 1957-58.

All the states asked for an increase in the number of commodities the duties on which should be shared. As regards the states' share of the divisible duties, Assam, Bihar, Bombay, Madras, Orissa, Punjab, Uttar Pradesh, West Bengal and Jammu and Kashmir suggested 50 per cent; Andhra Pradesh, Kerala and Madhya Pradesh 60 per cent; and Mysore and Rajasthan 70 per cent. Several suggestions were made about the principles of distribution of the shares allocated to the states. The Commission carefully considered the suggestion of a number of states that all excise duties should be shared and it came to the conclusion that for the time being it was neither necessary nor expedient to make such a sweeping change. But it felt it would be meeting the general wish of the states if the range was widened by increasing the number of duties to be shared. Therefore, it recommended that the three duties shared between the Union and the states according to the recommendations of the first Finance Commission, viz., duties on matches, tobacco and vegetable products, should be added the duties on sugar, tea, coffee, paper and vegetable non-essential oils. As to the states' share of these duties, keeping in view the sum proposed to be transferred to the states from Union duties of excise in the overall scheme of devolution, it recommended as 25 per cent. The reduction in the share allocated to the states out of the duties on tobacco, vegetable products and matches would be more than made good by the widening of the

range of divisible duties and each State would receive a larger sum from this source.

As regards the distribution of the states' share of the divisible excises, the first Finance Commission had suggested that consumption of the taxed commodities could provide a suitable basis for distribution, but in the absence of any reliable data of consumption, it recommended, population as indicating the nearest measure of consumption. It had also suggested that arrangements should be made for the collection of statistics of consumption of the more important commodities subject to Union excises. As such statistics were not available even to the second Finance Commission, it was in no better position than the first. Therefore, it expressed the opinion that while it is possible to hold that consumption, if accurate data were available, may provide a suitable basis of distribution, it must be borne in mind that distribution on the basis of consumption may operate in favour of the more urbanised states which are also in a position to raise substantial revenue from sales taxes on such consumption.[13] So the Commission felt it preferable to continue population as the sole basis of distribution. But as the practical effect of such distribution would be to place a few states in a more advantageous position in relation to the rest, it adopted the view that a small corrective should be applied in favour of the latter states. Therefore, it recommended that 90 per cent of the states' share of the divisible Union excise should be distributed on the basis of population, the balance of 10 per cent being used for adjustments. It also recommended that 25 per cent of the net proceeds in any financial year of the Union duties of excise on matches, tobacco (including manufactured tobacco), vegetable products, tea, coffee, sugar, paper, and vegetable non-essential oils be paid to the States.

Estate Duty

With regard to the principles of distribution of Estate duty, a variety of suggestions were made by the states to the second Finance Commission. The Commission was of the view that estate duty being a tax on property, the basis of location should be the most appropriate principle of distribution. But it felt that it was not possible to apply this principle in the case of the

part relating to movable property, which might be included in an estate, and in respect of it some general principle such as population is inescapable. Therefore, it recommended:

(1) That out of the net proceeds of the duty in any financial year, a sum equal to one per cent be retained by the Union as proceeds attributable to Union territories;
(2) the balance be apportioned between immovable property and other property in the ratio of the gross value of all such properties into assessment in that year;
(3) the sum thus apportioned to immovable property be distributed among the states in proportion to the gross value of the immovable porperty located in each State;
(4) the sum apportioned to property other than immovable property be distributed among the States in proportion of their population.

On the basis of the above principles, the percentage share of each state was worked out by the Commission.

Additional Duties of Excise

In respect of the additional duties of excise, the Commission was asked to make recommendations as to the principles which should govern the distribution of the net proceeds among the states and the amounts which should be assured to them as the income derived by them at that time from the levy of sales taxes on mill-made textiles, sugar and tobacco (including manufactured tobacco).

The Commission first considered whether in determining the then existing income and formulating the principles of distribution of the additional excise duties, it should take all the three commodities together or give separate figures for each. As the terms of reference gave no guidance to it in this respect, it made recommendations for the three commodities separately and for all of them together, both in regard to the sums to be guaranteed and the distribution of the net proceeds.

Turning to the determination of the amount of the then existing income assured to the states, it was urged by the States that this expression (present income) should be given a liberal interpretation so as to include prospective revenues likely to result from increase of rates for which legislation had been

passed or was likely to be passed in the near future. It was further claimed that the prospective yield in a full year of the centrally-levied inter-state sales tax, which had come into force on 1st July, 1957, should be taken into account in the determination of the then existing income. Some states even claimed that allowance should be made for the loss suffered by tax evasion and the amounts that might become available to them through improvement in the machinery of collection. But the Commission was unable to accept the claims for a wider interpretation of the expression "present income", and it decided that "present income" for any State should be the income which accrued to that state in the financial year 1956-57 from the levy of sales taxes on the three commodities mentioned above.

As the additional duties of excise were to replace the sales taxes which are taxes on consumption, the Commission explored the possibility of taking consumption as the basis for distribution. The National Development Council was also reported to have contemplated consumption as the basis. Therefore, the Commission made an attempt to estimate the State-wise consumption of the three commodities. The data available to the Commission were the consumption figures of mill-made cotton textiles, sugar and certain forms of tobacco contained in the report of the fourth round of the National Sample Survey, the estimates prepared by the Textile Commissioner, the statistics of the clearance or off-take of sugar prepared by the sugar and vanaspati. The data of consumption of tobacco contained in the Report on the Marketing of Tobacco of the Agricultural Marketing Directorate, prepared on the basis of surveys and enquiries undertaken in 1950-51. The Commission compared the estimates prepared on the basis of these data with those supplied by the state governments and it felt that sales tax being generally a turn-over tax, most states were not in a position to supply accurate figures either of collection or of consumption and it was of the opinion that as there was a considerable margin of error in the figures of consumption thus arrived at, it would be wrong to distribute the additional duties of excise solely on the basis of distribution, it used population as a corrective.

While some states supplied figures of collections, others

were not able to do so as they had no separate figures, and therefore, they gave the Commission only estimates. It checked them in the light of the consumption figures which it had computed according to the method explained above and the Commission believed that, on the whole, the figures of present income "arrived at by it represented for each state the nearest possible approximation to their income from sales taxes on these three commodities during the financial year 1956-57."

The Commission felt that the net proceeds from additional duties of excise might be distributed in one of two ways. The guaranteed amounts of "present income" might be made the first charge on the revenue from these additional duties, the balance being distributed among all states. Or, the net proceeds of these duties might be distributed independently of the guaranteed amounts, the Union making up the deficiency, if any that may arise in the case of any state. It came to the conclusion that the former method would be preferable as it would ensure for every state its guaranteed amounts plus some portion of any balance that might remain of the additional duties of excise; otherwise it might happen that while some states did not get from the distribution even the guaranteed amounts, others might receive sum in excess of the guarantee; in the former contingency, the Union would have to make good the deficiency. The Commission thought that while it might be reasonable to expect, that the proceeds of the additional excise duties would be greater than the total of the guaranteed amount, it did not see any justification for placing upon the Central revenues any burden arising out of the implementation of the guarantees.

Therefore, it decided that out of the net proceeds of the additional duties, the guaranteed amounts should first be paid to the states and the balance be then distributed among them. It recommended that:

(1) In respect of Union territories, 1 per cent of the net proceeds in any financial year of the additional duties of excise on each of the commodities, namely, mill-made textile, sugar and tobacco (including manufactured tobacco) be retained by the Union;

(2) A sum equal to one and a quarter per cent of such net proceeds be paid to the State of Jammu and Kashmir;

(3) Out of the balance of the net proceeds, i.e., after

deduction of the sums mentioned above, the following sums being the "present income" of the states on account of sales taxes be paid to them:

TABLE 8.2

(*Rupees in lakhs*)

States	*Mill-made Textiles*	*Sugar*	*Tobacco*
Andhra Pradesh	120	40	75
Assam	40	15	30
Bihar	80	30	20
Bombay	600	245	115
Kerala	38	20	37
Madhya Pradesh	83	40	32
Madras	168	60	57
Mysore	48	25	27
Orissa	50	20	15
Punjab	95	50	30
Rajasthan	50	25	15
Uttar Pradesh	400	112	63
West Bengal	204	36	40
Total	1976	718	556

(4) the remainder, if any, of the net proceeds be distributed in the percentage ratios applicable to each commodity as given in Table 8.3.

TABLE 8.3

State	*Percentage*		
	Mill-made textiles	*Sugar*	*Tobacco*
Andhra Pradesh	7.38	6.65	10.47
Assam	2.72	2.55	2.98
Bihar	11.19	8.20	8.90
Bombay	16.46	21.17	17.41
Kerala	3.10	3.03	3.43
Madhya Pradesh	6.97	7.67	7.10
Madras	7.26	7.43	9.53
Mysore	4.98	5.13	5.58
Orissa	3.32	2.87	3.21
Punjab	5.56	7.21	4.36
Rajasthan	4.36	4.81	3.59
Uttar Pradesh	18.19	15.63	16.13
West Bengal	8.51	8.65	7.31

If, for the purposes of the guarantees and the distribution of the net proceeds the additional duties were to be taken together, it recommended that in lieu of the sums and percentages recommended according to the above, the sums guaranteed and payable to and the percentage shares of the States be as shown in Table 8.4.

TABLE 8.4

States	*Sum to be guaranteed (Rupees in lakhs)*	*Percentage*
Andhra Pradesh	235	7.81
Assam	85	2.73
Bihar	130	10.94
Bombay	960	17.52
Kerala	95	3.15
Madhya Pradesh	155	7.16
Madras	285	7.74
Mysore	100	5.18
Orissa	85	3.20
Punjab	175	5.71
Rajasthan	90	4.32
Uttar Pradesh	575	17.18
West Bengal	280	8.31
Total	3250	

Tax on Railway Fares

As regards the tax on railway fares, population, needs of states in addition to population and a number of other criteria were suggested by the states for determining the basis of distribution among them. The Commission felt that "the ideal method would be to split up the tax collected on each ticket according to the mileage of the routes lying in each State". But this was found to be impracticable. The Commission was further of the opinion that "collection of passenger fares within a state will not reflect correctly the actual passenger travel within its limits on account of inter-state traffic; distribution based on figures of such collections would also be unfair to the states through which traffic passes without originating and terminating in them. The net proceeds due to passenger travel in a state

may, however, be determined with reasonable accuracy by allocating the passenger earnings among the states on the basis of the route mileage within each State, with due allowance for the wide variations in the density of traffic between the various railway zones and as between the various gauges in each zone. Hence, if the earnings of each zonal railway are allocated by route mileage located in each state separately for each gauge, this would give as nearly as possible, an allocating of passenger travel in terms of passenger earnings. The distribution of the tax in the ratio of the earnings thus allocated will give to each state a share that will approximate closely to the actual passenger travel in it.

The Commission took the figures of passenger earnings (exclusive of earnings of suburban services) for the last three years ending March 1956 for which actuals were available and worked out the shares of the States on the basis explained above.

The Third Finance Commission

General Approach

The Third Finance Commission was constituted by a Presidential order on the 2nd December, 1960 under the Chairmanship of Shri Ashok Kumar Chanda and its recommendations came into force with effect from the 1st April, 1962 for a period of four years.

The general approach that this Finance Commission adopted was, in a large measure, similar to that adopted by the second Finance Commission. The Commission felt that the rate and function of the Finance Commission, as provided in the constitution as an independent body to make an assessment of the needs of the states as well as the measure of assistance to be afforded and the form in which this should be given, could no longer be realized fully due to the emergence of the Planning Commission as an apparatus of national planning.[14] As a prelude to the formulation of each five year plan the Planning Commission makes an assessment of resources required in their totality including these to be raised by the Union and the states, both by way of loan and by additional taxation and adjustment

of existing levels of taxes, foreign assistance and deficit financing.

Based on this assessment, the size of the national plan is determined and is divided into components of industrial and social development, individually for the Union and each State Government and priorities are arranged. The overall planning embraces an examination and acceptance of the revenue and expenditure forecasts of the Union and the state governments; additional tax efforts to be made are similarly pre-determined as requisites of the fulfilment of the plan. In this background the Third Finance Commission realised that its role was, at best, that of an agency to review the forecasts of revenue and expenditure submitted by the states and the acceptance of the revenue element of the plan as indicated by the Planning Commission for determining the quantum of devolution and grants-in-aid to be made; and at worst, its function was merely to undertake an arithmetical exercise of devolution based on amounts of assistance for each State already settled by the Planning Commission to be made under different heads on the basis of certain principles to be prescribed.

Thus the third Finance Commission felt like the second Finance Commission that there was an overlap of functions of the Planning and Finance Commissions and, therefore, this Finance Commission also urged the real need for effectively co-ordinating the work of the two Commissions. It emphasised the desirability of eliminating the necessity of making two separate assessments of the need of the States. Therefore, it recommended the acceptance of any of the two alternatives to remove the anomalous position. The first alternative suggested by it was to enlarge the functions of the Finance Commission to embrace total financial assistance to be afforded to the states, whether by way of loans or devolution of revenues, to enable them both to balance their budgets and to fulfil the prescribed targets of the Plans. This was considered by it to be in harmony with the spirit and even the express provisions of the Constitution. It also felt that as a result of it the Finance Commission's recommendations would become more realistic because they would take account of the inter-dependence of capital and revenue expenditure in a planned programme. The second alternative suggested by it was to transform the

Planning Commission into a Finance Commission at the appropriate time. But none of these alternatives suggested by the Finance Commission was accepted by the Union Government and the anomalous position persisted.

The third Finance Commission drew pointed attention to some of the disturbing features emerging in the Indian Fiscal System. One such feature was, to which the states had also drawn the attention of the Finance Commission, that their autonomy was being diluted not only by the prescription of detailed directions on subjects within the State list but also by unilateral financial decisions taken by the Union Government. The second feature was the increasing dependence of the States on Central Financial assistance arising partly out of the impact of committed expenditure of the completed plan projects and partly for other reasons. This increasing dependence was diluting, on the one hand, the accountability of the State cabinets to their legislatures, and on the other, it was coming in the way of the development of a greater sense of responsibility in their administration. The increasing need for Central assistance, therefore, is not entirely a concomitant of planning; in many cases it is additionally attributable to ineffective expenditure control and laxity in fuller mobilisation of available resources under the existing arrangements. The cost of maintaining the completed schemes became automatically a charge on the revenues of the states, though many of these schemes did not produce sufficient revenues to meet their maintenance charges and so they added to the financial liabilities of the states. Therefore the Finance Commission suggested that the schemes which have been completed but have not become viable should become the first charge on the resources of the succeeding plan. This arrangement would provide, on the one hand, for a review of the working of the schemes, whether they are being efficiently and economically administered and whether they are fulfilling the purposes for which they were designed, and on the other, make it possible to assess the extent to which the different states more endeavouring to balance their 'normal' budgets.

Another disturbing feature pointed out by the commission was the lack of efficiency and economy in administration by the state and an allergy on their part to tap resources in the rural sector and a disinclination to make up the leeway in others.

This was because they were confident that their budgetary gap would be fully covered by devolution of Union resources and grants-in-aid. The unsound financial policies of a state not only effected its own development but had an impact on neighbouring states also. In the field of land revenue, sales tax and motor vehicles tax considerable disparities existed among the various states.

In view of these disturbing features in the finances of the states, the third Finance Commission recommended the establishment of an independent commission to assess the tax potential of each state, to review its tax structure and to recommend rates under different heads of levies in the State list. In the context of the inadequacy and unreliability of the statistical and other materials, the Finance Commission was unable to assess the relative efficiency and performance of the different states and it was forced to make recommendations to cover the annual budgetary gaps of all the states, whether covered by normal growth of expenditure, the maintenance cost of completed schemes and mounting interest charges or even by a measure of improvidence.

Income tax

With regard to the devolution of resources from the proceeds of income tax the Finance Commission adopted the view that in case of a divisible tax in which there was obligatory participation between the Union and states, a sound maxim to adopt could be that participating governments, more particularly the one responsible for levy and collection, should have a significant continuing interest in the yield of the tax. At the same time, the commission took into account the views of the states for a larger share in the net proceeds of income. The states had pointed out that as a result of the charge brought about in the income tax and by the Finance Act of 1959, the income tax paid by companies was classified as comparative tax and thus excluded from the pool of income tax so far available for distribution. Thus they had been deprived of an expanding source of revenue to which they were constitutionally entitled. The states had, therefore, submitted before the commission to take into account at least such point of the corporation tax as was

attributable to this yield, if not the entire tax. The states also pointed out that surcharges levied on income tax should be merged in the basic rates because this would abate partly the impact of the loss sustained as this would indirectly bring within the pool of distribution an excluded amount. The Commission, however, did not accede to these demands of the state governments since it thought they were beyond its terms of reference and were not in accordance with the provisions of the constitution.

On a balance of all the arguments the commission recommend that 66.66 per cent of the net proceeds of income tax in any financial year be distributed among the states.

As regards the distribution of the divisible pool of income tax among the states, the Third Finance Commission adopted the criteria of the First Finance Commission that 80 per cent be distributed on the basis of population and 20 per cent on the basis of collection. It took the view that "while population should remain the main factor for the distribution of the net proceeds of income tax among the States, the factor of contribution should receive adequate recognition."[15] The industrial and urban states had urged before the commission that since a large amount of the tax was collected in their territory, they should have an incentive to enable them to maintain the environment which would preserve and promote industrial and trade activities. These states with large concentration of population had their own problems of law and order and larger demand for administrative and social services. Besides the unit cost of providing there services is larger in such areas. The First Finance Commission had argued that "there may be a case for weightage being given to collection in the restricted view of personal income tax" because there is all over the country a case of income, particularly in the range of personal and small business incomes, which could be treated as of local origin. The Third Finance Commission was convinced that this argument had force. Since taxes on income paid by companies were excluded from the divisible pool, a higher percentage than before of the total yield of income tax came to represent tax derived from incomes, of local origin. On there considerations, it gave a higher weightage to the factor of contribution in the distribution of income tax than that recommended by the

second Finance Commission. On the basis of the criteria of distribution evolved by it the Commission recommended the following share of each State in the divisible pool of income tax. (see Table 8.5)..

TABLE 8.5

State	*Percentage*	*State*	*Percentage*
Andhra Pradesh	7.71	Maharashtra	13.41
Assam	2.44	Mysore	5.13
Bihar	9.33	Orissa	5.44
Gujarat	4.78	Punjab	4.49
Jammu & Kashmir	0.70	Rajasthan	3.97
Kerala	3.55	Uttar Pradesh	14.12
Madhya Pradesh	6.41	West Bengal	12.09
Madras	8.13		

Thus, it is clear that the scheme of allocation tilted the scales in favour of the industrially developed states of Maharashtra and West Bengal. The recommendation of the third Finance Commission in so far as it gave a weightage of 20 per cent to collection was also not justified because in a national economy it is just arbitrary to argue that a certain percentage of the income arising in an area is of entirely local origin. On the other hand, the creation of national income is a function of the totality of conditions operating over the national economy as a whole and even local business and trade depends on the conditions prevailing in the national economy. Thus, it is not justified to assign any importance to the local factor in a question which is of national importance. The scheme of allocation, therefore, was guided more by compromise and a desire to satisfy the claims of the industrially advanced states rather than by a consideration of fiscal equity and sound economic reasoning.

Union Excise Duties

The Commission had three alternatives before it with regard to the distribution of the proceeds of Union excise

duties among states: (a) the distribution should cover the proceeds of Union excise duties on articles of common consumption, (b) consumer goods and (c) all the commodities for the existing list. The Commission adopted the third alternative and recommended that 20 per cent of the net proceeds of Union excise duties on all commodities on which such duties were collected and the yield of which exceeded Rs. 50 lakhs in 1960-61 should be allocated to the states. The Commission took a number of factors into consideration while making this recommendation. It took into account the shrinkage in the divisible pool of income tax and the larger revenue gaps caused by the impact of committed expenditure of two successive five-year plans which had to be filled up. Besides the expansion of the range of commodities subjected to union excises from time to time and the increasing incidence of duty produced adverse effects on the levy and collection of sales tax by the states. Thus the two levies—in Union excise and state sales taxes—are interdependent making the entire proceeds of union excise duties divisible. Besides, sales taxes contributed the only flexible source of revenue available to the States and this flexibility was subject to restraint by the excise policy of the Union Government. The Commission was convinced that inadequacy of resources of the states was mainly attributable to the planning process and this inadequacy was going to be more pronounced with the completion of each successive plan. It felt that the viability of the states could best be secured by a larger devolution of the union excise duties which was possible only by providing for the participation of the state in the proceeds of all Union excise. It would also give a great deal of psychological satisfaction to the states and dissipate any suspicion that the Union was pursuing a policy of centralisation of resources.

The share of each state in the distribution of Union excises was determined by it on the basis of population and it rejected consumption as the basis of population and it rejected consumption as the basis of distribution since reliable data of consumption were not available. But the more important consideration for rejecting consumption as the basis was that it would give advantage to the more urbanised and financially stronger States. The schedule of distribution was as indicated in Table 8.6.

TABLE 8.6

State	Percentage	State	Percentage
Andhra Pradesh	8.23	Maharashtra	5.73
Assam	4.73	Mysore	5.82
Bihar	11.56	Orissa	7.07
Gujarat	6.45	Punjab	6.71
Jammu & Kashmir	2.02	Rajasthan	5.93
Kerala	5.46	Uttar Pradesh	10.68
Madhya Pradesh	4.46	West Bengal	5.07
Madras	6.08		

Additional Duties of Excise

In May 1957 the Government of India in consultation with the state governments decided that an additional duty of excise be levied on mill-made textiles, sugar and tobacco including manufactured tobacco, rayon or artificial silk fabrics and woollen fabrics in replacement of sales tax levied by the state governments and that the net proceeds should be distributed among them subject to the then income derived by each state being assured to it. The Commission rejected the contention of the states to revise the guaranteed amounts because the rates of sales taxes had been revised by them since then. They also complained that they had lost over a period of years and they should be insulated against further future losses. The Commission felt that such an estimate was not practical on the basis of the available statistical material. The Commission, therefore, distributed the guaranteed amount of Rs. 32.54 crores among the states and the remaining amount was distributed, first, on the basis of the percentage increase in the collection of sales tax in each state since 1957-58 when the additional excise duties were imposed and then, on the basis of population.

Estate Duty

The Third Finance Commission left undisturbed the principles enunciated by the second Finance Commission for the distribution of its proceeds among the states. The percentages, however, as laid down by the second Commission were revised

on the basis 1961 Census.

The revised percentages were as shown in Table 8.7.

TABLE 8.7

State	*Percentage*	*State*	*Percentage*
Andhra Pradesh	8.34	Maharashtra	9.16
Assam	2.75	Mysore	5.46
Bihar	10.78	Orissa	4.08
Gujarat	4.78	Punjab	4.71
Jammu & Kashmir	0.83	Rajasthan	4.67
Kerala	3.92	U.P.	17.10
M.P.	7.51	West Bengal	8.11
Madras	7.80		

Ad-hoc Grant in lieu of Tax Railway Passenger Fares

The Act imposing a tax on railway passenger fares was repeated after the Third Finance Commission had been constituted. The Union government, however, decided to make the states an *ad hoc* grant for the period 1961-66 of Rs. 12.5 crores per year representing the average of the actual collections during the two years 1958-59 and 1959-60. The Commission, therefore, was asked to recommend the principle on which the *ad hoc* grant should be distributed among the states. The Finance Commission adopted the principle of compensation on which the grant should be distributed among the states to place them broadly on the same footing as before. The distribution of the sum of Rs. 12.5 crores per year among the states was as shown in Table 8.8.

TABLE 8.8

Rupees in crores

Andhra Pradesh	1.11	Mysore	0.56
Assam	0.34	Orissa	0.22
Bihar	1.17	Punjab	1.01
Gujarat	0.68	Rajasthan	0.85
Kerala	0.23	Uttar Pradesh	2.34
Madhya Pradesh	1.04	West Bengal	0.79
Madras	0.81		
Maharashtra	1.35		

Impact of the Recommendations on the States' Finances.

The above recommendations of the Third Finance Commission involved a much larger devolution of resources to the states as compared to the resources transferred to them under shared taxes in accordance with the recommendations of the Second Finance Commission. Table 8.9 indicates tax, estate duty and union excise duties for the period of four years from 1962-63 to 1965-66.

TABLE 8.9

	1962-63	*1963-64*	*1964-65*	*1965-66*	*Total*
1. Income tax	95.20	119.29	123.77	137.09	475.35
2. Union excise including additional excise duties	124.91	135.99	127.34	145.92	534.16
3. Estate duty	3.88	4.22	6.78	6.79	21.67
Total	223.99	259.50	257 89	289.80	1031.18

During the period of the Second Five Year Plan the entire revenues allocated to the state over the five year from 1956 to 1961 over these heads were as follows:

(In crores of Rupees)

1. Income tax	377.2
2. Union excise	242.0
3. Estate duty	12.8
	632.0

Thus over the four year period from 1962-66 the resources transferred under the above heads represented a little less than double the amount over the period of five years of the Second Plan. The increase, however, represented partly the buoyancy in Central tax revenues particularly from excises and partly the results of the recommendations of the Third Finance Commission which brought all the Union excises existing at the time under the category of divisible revenues.

The Fourth Finance Commission

General Approach

The fourth Finance Commission was constituted in May 1964 with Dr. P.V. Rajamanar as Chairman. Unlike the previous three Finance Commissions the terms of reference of the fourth Finance Commission were as under in scope. The fourth Finance Commission was also called upon to study the combined incidence of union excise duties and sales taxes of states on production, consumption and export of articles, the duties on which are shared between the Centre and the states and to make adjustments in the states' share of union excise duties in case the sales tax levied by a state excluded a certain level specified by the Commission.

In its report, the Commission suggested that there should be greater co-ordination between the Centre and the states in common financial interests and for this it recommended the establishment of a permanent organisation in the Ministry of Finance for making a continuous study of and bringing up-to-date information on various matters required by the Finance Commission and the constitution of a competent body to study in depth the entire problem of indebtedness of states and allied aspects. The Commission also drew attention to the inadequacy and lack of uniformity of budgetary provisions of states for amortisation of market borrowings and recommended an enquiry through a representative expert body for deciding the principle of a scheme of amortisation of public borrowings by states whose recommendations should form the basis on which all state governments might recense their expenditure forecast for the next five years. The Commission also expressed an opinion in favour of conducting a survey for assessing the soundness of the existing system of inter-governmental borrowing. But these recommendations of the Commission were not accepted by Union Government.

As regards the assessment of the continued incidence of states' sales tax and Union excise duties on production, consumption and export of commodities, the duties which were sharable with the states, the Commission observed that in the absence of commodity-wise detailed cost analysis studies as well

as data on effective incidence of sales tax and excise duties on the commodities, it was not possible to determine precisely the impact of any increase in these taxes on production, consumption or exports of such commodities. The Commission, therefore, came to the conclusion that for lack of adequate data for determininig the combined incidence of the two taxes and their economic effects, the question of fixing the ceiling and deriving a formula for adjustment in the share of Union excise duties could not be considered.

Income tax

With regard to the allocation of the net proceeds of income tax to the states, the states submitted to the Commission that there was a case for a substantial increase in their share from the then existing level of 66.66 per cent. They argued that as a result of the change in the classification of the income tax payable by the companies since the Finance Act of 1959 the rate of growth of divisible pool of income tax had been adversely affected. Secondly, they also pointed out that while collections from the corporation tax had increased over six times in the last 12 years, the growth in the divisible pool of income tax had been less than 50 per cent. Thirdly, they also reiterated the view that during normal times there was no need for the levy of any surcharge exclusively for the Union and that in case a surcharge was levied, it should, as a matter of course, be managed with the basic rate of income tax after a period of three years.

The Commission, after considering the view of the states as well as that of the Third Finance Commission and the forecasts of collections of income tax revenues supplied by the Finance Ministry, come to the conclusion that some further increase in the states' share was justified. It, therefore, recommended that 75 per cent of the divisible pool of income tax shall be assigned to the states for distribution among them.

With regard to the distribution of states share' among themselves of the various factors as bases for distribution put forward by the states only two, namely, population and combination were considered relevant in the opnion of the Commission. Further, the Commission was also of the opinion that feeling of

certainty and stability should be imparted as regards the principle governing the distribution of income tax. Accordingly, it retained the formula recommended by the First and the Third Finance Commissions for determining the share of each state in the divisible pool of income tax, viz., 80 per cent on the basis of population and 20 per cent on the basis of collection. The Commission also retained by applying the same principles of population and collection the share of Union territories in the divisible pool of income tax at 2.5 per cent.

Union Excise Duties

The Commission granted the Union excise duties then in force into six categories: (*i*) basic excise duties, (*ii*) Cesses or excise duties levied on certain items such as Copra, salt, iron ore, coal, oilseeds, dhoties, etc., under special Acts, the proceeds of which are ear-marked for specified uses, (*iii*) additional excise duties in lieu of sales tax on sugar, tobacoo and textiles, (*iv*) additional excise duties on motor spirit, kerosene, refined diesel oils and vapourising oil, diesel oils not otherwise specified and furnace oil, (*v*) special excise duties on certain goods levied in the form of surcharges on basic duties and (*vi*) regulatory duties.

The Commission recommended that all Union excise duties then levied except regulatory duties, special excises and duties and cesses earmarked for special purposes as also those might be levied in the next five years, should be shared between the Union and the states. As regards the share of the states in the distributable excises, the Commission fixed it at 20 per cent which, in effect, amounted to a distribution of 30 per cent if the Commission had confined itself to the net proceeds of the 35 commodities recommended by the third Commission.

In regard to the sharing of the proceeds from excise duty among states, the fourth Finance Commission made a departure relating to the principle of distribution and rccommended that the share of the states should be determined on the basis of 80 per cent on population and 20 per cent on economic and social backwardness as indicated by the per capita gross value of agricultural production, per capita value added by manufacture, percentage of workers (as defined in the census to total

population). Thus, the Commission made a distinction between economic and social backwardness and its financial weekness because according to the Commission "it is possible that a State may be economically backward and poor in social service and yet it may have a comfortable position on revenue account". The Commission was of the view that financial weakness as a criterion would be more appropriate in determining the grants than in allocating shared taxes.

Additional Excise Duties in lieu of Sales Tax

It has already been pointed out that from the inception of the scheme, the states had been assured that each of them would get by way of its share an amount not less than the revenue realised by it in 1956-57 from the sales taxes on the specified commodities. The Finance Commission was required to determine the basis for distribution of additional amounts over and above the guaranteed amounts. The Commission recommended that of the net proceeds of additional excise duties in lieu of sales tax from the years 1966-67 to 1970-71, one per cent be assigned to Union territories, 1.5 per cent to the State of Jammu and Kashmir, one-twentieth of one per cent to the State of Nagaland and of the balance (97.45 per cent) of the net proceeds, the guaranteed amount of Rs. 32.54 crores be set apart and the rest distributed on the basis of the population which sales tax revenue collections in each state bore to total sales tax revenues of all states over the years 1961-62 to 1963-64. The fourth Finance Commission differed with the third Finance Conmission in this regard and it considered that collections of sales tax in a state are more direct indicator of the contribution made by each state to the divisible surplus than population.

Estate Duty

The fourth Finance Commission retained the principles governing the distribution of estate duty as recommended by the second Finance Commission and endorsed by the third except for raising the share of union territories from 1 per cent to 2 per cent after taking into account population and value of

immovable property assessed in these territories in the recent years.

Grant in lieu of Taxes on Railway Fares

The Commission did not suggest any change in the principles governing the distribution of the grant among states payable under this head. However, in view of the fact that the period of the *ad hoc* grant in lieu of taxes on railway fares was to expire at the end of 1965-66 and the Railway Convention Committee's recommendations about the future quantum of grant had not been received by them, the Commission recommended that the percentage share of each state be based on the latest available statistics of railway route length in each state and the annual earnings from passenger traffic excluding sub-urban traffic for three years ending 1964.

The recommendations of the fourth Finance Commission may be summarized in Table 8.10.

TABLE 8.10

	Share of income tax	*Share of Union Excise Duties*	*Share of Estate Duty*	*Grant in lieu of tax in Railway passenger fares*	*Additional Duties of Excise in lieu of Sales Tax*	
					Income to be assured	*Distribution of balance*
States' Shares	*75%*	*20%*	*98%*		*97.45%*	
1	*2*	*3*	*4*	*5*	*6*	*7*
Distribution	*Per cent*	*Per cent*	*Per cent*	*Per cent*	*Lakhs of rupees*	*Per cent*
Andhra Pradesh	7.37	7.77	8.34	9.05	235.24	7.42
Assam	2.44	3.32	2.75	2.79	85.08	1.98
Bihar	9.04	10.03	10.76	9.99	130.16	6.17
Gujarat	5.29	4.80	4.78	7.11	323.45	7.43
Jammu & Kashmir	0.73	2.26	0.83	—	—	—
Kerala	3.59	4.16	3.92	1.85	95.08	5.65
Madhya Pradesh	6.47	7.40	7.50	9.85	155.17	4.62
Madras	8.34	7.18	7.80	5.81	285.34	11.13
Maharashtra	14.28	8.23	9.16	8.98	637.77	19.87
Mysore	5.14	5.41	5.46	3.98	100.10	5.21

1	2	3	4	5	6	7
Nagaland	0.07	2.21	0.09	0.01	—	—
Orissa	3.40	4.82	4.07	2.12	85.10	2.58
Punjab	4 36	4.86	4.70	7.43	175.19	5.01
Rajasthan	3.97	5.06	6.67	6.40	90.10	3.17
Uttar Pradesh	14.60	14.98	17.08	18.23	575.81	7.83
West Bengal	10.91	7.51	8.09	6.40	280.41	11.93
					3,254.00	

The Fifth Finance Commission

The fifth Finance Commission was appointed in February 1968 with Shri Mahavir Tyagi as Chairman. The Commission made an interim report in October 1968 and it submitted its final report on July 31, 1969. The terms of reference of this commission were wider than those of the earlier ones. Apart from the matters referred to the earlier commissions, this commission was required to examine and make recommendations in regard to the following:

(*a*) The desirability or otherwise of maintaining the existing arrangements in regard to additional excise duties levied in lieu of Sales tax and the scope for extension of such arrangements to other items,

(*b*) The scope for raising revenue (*i*) by levying those taxes and duties enumerated in Article 269 of the Constitution which are not levied at present, and (*ii*) from other sources of revenue available to the States and,

(*c*) The problem of unauthorised overdrafts of certain States with the Reserve Bank of India.

The recommendations of the commission covered a period of five years from 1969-70 to 1973-74.

Income tax

For the period 1969-74 to 1973-74, the Commission raised the share of Union territories in the net proceeds of income tax to 2.6 per cent. The Commission retained the States' share in the divisible pool at 75 per cent. But the inclusion of advance tax collections enlarged the size of the divisible pool. The Commission considered *de novo* the principle governing the

distribution among states *inter se* of shares assigned to them. It gave 90 per cent weightage to population and 10 per cent to the factor of assessments in recommending the share of each state. This is what the second Finance Commission had also done. The Commission in this regard took into account the consideration of equity and the objective of securing a more balanced correspondence between needs and resources of states in widely varying circumstances and as a result raised the percentage assigned to the factor of population to the same level as recommended by the second Finance Commission. In its view population was a general measure of need.

The fifth Finance Commission, however, made a significant departure for the previous commissions in which it adopted assessments as a measure of contribution in place of collection adopted by the previous Commissions. In its opinion, collection as an index of contribution contained several drawbacks: it failed to make any allowance for incomes originating outside the states; and, moreover, in view of deductions at source in respect of dividend and interest income etc., adoption of collections as a basis tended to favour States being metropolitan and industrial centres.

Union Excise Duties

The Commission after taking into account the anticipated revenue resources and expenditure of the Government of India and the states during the period 1969-70 to 1973-74 recommended the continuance of the States' share in the Union (basic) excise duties at 20 per cent, the same as recommended by the third and fourth Finance Commissions. At the same time, the Commission somewhat enlarged the size of the divisible pool by recommending inclusive of the proceeds of special excise duties in the divisible pool for the two years 1972-73 and 1973-74. The proceeds of regulatory duties and duties and cesses levied under special Acts were however, kept out of the divisible pool. With regard to special excises, the Commission was of the opinion that if these duties were continued on a long-term basis, it would be desirable to include them in the divisible proceeds. At the same time, it did not consider it necessary to recommend inclusion of duties in the divisible pool for the first

three years from 1969-70 to 1971-72. The Commission, however recommended inclusion of the special excise duties in the divisible pool for the last two years, i.e., 1972-73 and 1973-74 if such duties were continued till then.

With regard to the distribution of the divisible pool of excises among the states the Commission was guided by the view that the main purpose of devolution was to augment the resources of the states in an equitable manner to enable them to meet their growing needs. In its view, the needs of the states depended mainly on the size of their population, their relative income, resources and levels of economic development. Therefore, it was not in favour of giving any weightage to the factor of contribution since it did not consider it as an appropriate factor in distribution of tax that is shared on a discretionary basis. It did not consider consumption also as appropriate for this purpose since it would operate to the disadvantage of less urbanised states. The Commission considered that the distribution should be based mainly on population together with some criteria to take into account lower potential for raising resources and relative backwardness in economic and social development of states. The Commission thought that the states with lower level of per capita income tended to have lower potential for raising resources and so were placed at a disadvantage as compared to the states with higher lavel of per capita income.

Therefore, it assigned a weightage of 80 per cent to the factor of population and of the remaining 20 per cent, it recommended that two-thirds be distributed among states where per capita income was below the average per capita income of all states, the share of each state being determined in proportion to the shortfall of the states' per capita income from all states' average multiplied by the population of the state. The balance one-third (out of 20 per cent) was distributed among states on the basis of an integrated index of backwardness. For working out the index of backwardness, the Commission considered six factors, viz., (*i*) scheduled tribes population, (*ii*) number of factory workers per lakh of population, (*iii*) net irrigated area per cultivators (*iv*) length of railways and surface roads per 100 square kilometres, (*v*) shortfall in number of school-going children as compared to those of school-going age, and (*vi*) number of hospital beds per 1000 population.

Additional Duties of Excise in Lieu of Sales Tax

In addition to making recommendations on principles governing the distribution of the net proceeds of additional duties of excise, the Commission was required to examine the desirability or otherwise of maintaining the existing arrangements and the scope for extending such arrangements to other items or commodities. The Commission examined in detail the desirability of maintaining the existing system. The main grievances of the states against the scheme were that in the past the Government of India did not raise the rate of additional excise duties although it had raised the basic excise duty rates and also that it imposed special excise duties on certain articles and, therefore, the existing scheme had deprived the states of a potential source of revenue.

The Commission was impressed by the views expressed by the states. It found that between 1957-58 and 1967-68 revenues from basic and special excise duties on tobacco, sugar and textile increased by more than 70 per cent whereas those from additional excise duties on these items rose by 45 per cent during the same period. The Commission was also impressed by the fact that the rates of sales tax levied by some of the states on comparable items like kerosene, matches, tea, coffee, etc., were generally higher than the incidence of additional excise duties on tobacco, sugar and textiles and that if the states were free to levy sales tax on these items many of them would have been able to realise more tax revenues from the items than they actually received from additional excise duties levied by the Union Government. The Commission, however, was convinced of the rationale of the scheme and its advantages. The Commission did not make recommendation in regard to the extension of the scheme to other items or commodities. The Commission, however, recommended that if the existing arrangements were to continue, the rates of duties should be made *ad valorem* as far as possible and should be revised periodically to secure reasonable incidence having regard to prevailing prices and general level of sales taxes on similar items levied by the States.

The Commission raised the share attributable to union territories and Nagaland from 1 per cent and 0.05 per cent to

2.05 per cent and 0.09 per cent respectively but reduced the share of Jammu and Kashmir from 1.5 per cent to 0.83 per cent. They were fixed on the basis of population in place of earlier fixation which had been made on *ad hoc* basis. The fifth Finance Commission like the previous two Commissions was also not in favour of reopening the question of determining the guaranteed amounts. However, the guaranteed amount recommended by the Commission was lower by 0.54 crore as a result of reduction in the combined share of Punjab and Haryana following the inclusion of Chandigarh under union territories.

In respsct of distribution of the excess over the guaranteed amount the fifth Finance Commission did not accept the view of the fourth Finance Commission because it felt that the factor of sales tax collection which was made the basis of distribution by the fourth Finance Commission had certain limitations in difference in rates from state to state, larger realisation in richer states on account of higher consumption of luxuries and semi-luxuries on which higher rates of sales tax were imposed. Although the Commission felt that consumption was theoretically the best criterion for distribution, data available in this regard were not adequate. Thus consumption figures could not provide a satisfactory basis for distribution. Taking all factors into account, the commission came to the conclusion that the excess over the guaranteed amount should be distributed partly on the basis of sales tax collections (excluding inter-state sales tax) during the years 1965-66 to 1967-68, equal weightage being given to both the factors.

Estate Duty

The share of union territories in the net proceeds from estate duty was raised from 2 per cent to 3 per cent after taking into account the increase in the population of these territories consequent on the inclusion of Chandigarh as well as the gross value of immovable effects located therein and brought into assessment in the five years ending 1966-67. The principles governing the distribution of the balance among States remained the same as recommended by the earlier Commission.

Grant in Lieu of Tax on Railway Passenger Fares

In regard to allocation among states of the grant in lieu of tax on railway passenger fares also the principles remained the same as recommended by the fourth Commission.

Summary

The following is the summary of the recommendations of the fifth Finance Commission with regard to resource allocation out of shared and assigned taxes among the States (See Table 8.11).

TABLE 8.11

States	*Share in income tax (per cent)*	*Share in union excises (per cent)*	*Share in additional excise duties Guaranteed amount (Rs. in lakhs)*	*Rate (per cent)*	*Estate duty (per cent)*	*Grant in lieu of tax on passenger fares (per cent)*
Andhra Pradesh	8.01	7.77	235.24	7.42	8.37	8.56
Assam	2.67	3.32	85.08	1.98	2.76	2.88
Bihar	9.99	10.03	130.16	6.17	10.80	10.86
Gujarat	5.13	4.80	232.45	7.43	4.80	6.91
Haryana	1.73	1.49	65.49	—	1.76	2.46
Jammu & Kashmir	0.79	1.12	—	—	0.83	0.01
Kerala	3.83	4.28	95.08	3.65	3.93	1.78
Madhya Pradesh	7.09	8.48	155.17	4.62	7.53	9.92
Maharashtra	11.34	7.93	637.77	19.87	9.20	9.12
Mysore	5.40	4.65	100.10	5.21	5.48	3.83
Orissa	3.75	4.72	85.10	2.58	4.08	2.36
Punjab	2.55	2.12	96.07	5.01	2 59	4.76
				(including Haryana and Chandigarh		
Rajasthan	4.34	5.28	90.10	3.17	4.68	6.43
Tamil Nadu	8.18	6.50	285.34	11.13	7.83	5.54
Uttar Pradesh	16.01	18.82	575.81	7.83	17.15	19.06
West Bengal	9.11	6.84	280.41	11.93	8.12	5.51
Nagaland	0.08	0.08	—	—	0.09	0.01

The Sixth Finance Commission

The sixth Commission was constituted by a Presidential order dated the 28th June 1972 with Shri K. Brahmanand Reddy as Chairman. Its recommendations covered the financial years from 1974-75 to 1978-79. The terms of reference of this Commission were much wider than those of the earlier Finance Commissions. Apart from the matters referred to the earlier commissions, this commission was to make the assessment of the non-plan capital gap of the states on a uniform and comparable basis for the above five years. In the light of such an assessment, the Commission had to undertake a general review of the states' debt position with particular reference to the Central loans advanced to them and likely to be outstanding as at the end of 1973-74 and suggest changes in the existing terms of repayment having regard to the overall non-plan gap of the States, their relative position and the purposes for which the loans had been utilised and the requirements of the Centre. The Commission had also to review the policy and arrangements in regard to the financing of relief expenditure by the states afforded by natural calamities and examine the feasibility of establishing a National Fund to which the Central and State governments might contribute a percentage of their revenue receipts.

Indicating its general approach to leading issues of current interest in the sphere of fiscal relations between the Union and the states, the Commission thought it more purposeful to confine itself to delivering certain directions in which new initiatives needed to be attempted without disturbing too violently the delicate framework painstakingly worked since the introduction of the Constitution. The Commission maintained that the financial provisions embodied in the Constitution give enough room for reconciling such conflicts of interest as might arise from time to time between the Union and the constituent units. The Commission was not convinced with the soundness of the argument that the revenue resources of the states have been less elastic than those of the Union because if the resources transferred through sharable taxes be included, the States' tax revenues have increased faster than the tax revenues of the Centre. Besides if the States had been

less reluctant to tap the rural sector and secured reasonable rates of return on investments in irrigation and power projects, the states' revenues would have increased at a faster rate. In its view the difficulties which have been experienced from time to time in the field of Centre-State financial relations are not due primarily to the particular pattern of distribution of resources as laid down in the Constitution but because of the fact that the rate of growth of the economy has not been fast enough to meet the raising expectations of the people and the potentials for resource mobilisation have not been fully explained. The Commission also drew attention to the problems of tax arrears, tax avoidance and evasion and their solution constituted a basis for an ending solution of the problems of Centre-State financial relation. An achievement of a high level of efficiency in fiscal administration and management also constituted an important aspect of the solution of the problem.

The Commission thought that it would be more appropriate to view the problem as one of distribution of available resources as between the subjects falling constitutionally within the competence of the Centre and the States rather than to regard it in terms of distribution between the Centre and the State.

Income Tax

The Commission took note of the viewpoints of the states for a larger devolution of resources and it suggested that the question of borrowing corporation tax in the divisible pool be brought for examination before the National Development Council. In its view there was no reason to apprehend that the inclusion of corporation tax in the list of sharable taxes would upset seriously the relative balance between Central and state resources. The States' share of the combined divisible pool of income tax and corporation tax could be fixed at a suitably lower level that took note of the essential needs of the Centre.

The Commission in the meantime recommended that the States' share of the net proceeds of income tax be raised from 75 to 80 per cent for the period covered by its award. In doing so it took into consideration a number of factors. Like the previous Commissions this was also of the view that the Centre which is responsible for the levy and collection of the income

tax should continue to have a significant interest in it. Besides the Union surcharges on income tax had been raised from 10 to 15 per cent in 1971-72 thus increasing the resources of the Centre. But the addition of advance tax collections to the divisible pool including a sum of Rs. 270 crores representing the unadjusted balances of advance tax collection up to 1966-67 had resulted in an appreciable increase in the resources of the states from their share of the income tax during the period covered by the fifth Commission. But the arrear element due to advance tax collection no longer existed and this called for a larger share to the states.

As regards the manner of distribution among the States of the net proceeds of income tax, the states had put forward very divergent views, but the Commission endorsed the views of the earlier Finance Commission that population and contribution are the only two relevant factors. This is because there are advantages in our complex Federal system in maintaining a reasonable measure of stability in the principles of distribution of sharable taxes and also because we are seeking to mitigate the economic disabilities of some of the States through weightage for relative economic backwardness in the distribution of union excise duties and grants-in-aid for upgradation of standards of administrative and social services. The Commission felt that in view of the increasing integration of our national economy and the influence of central policies on the location and development of industrial and tertiary sectors, it is difficult to assign the factor of contribution any higher weightage than existing at that time in the distribution of income tax. Besides, further enhancement of the weightage of contribution would aggravate regional imbalances. The Commission accepted the proposal that a small but not clearly identifiable percentage of personal incomes should be demanded to have purely local origin.

Taking all these factors into account, it decided that 10 per cent of the net proceeds of income tax be distributed among the states on the basis of contribution. With regard to the measurement of contribution, the sixth Commission accepted the viewpoint of the fifth Commission that assessment was the best measure of contribution for the same reasons put forward by the fifth Commission. In arriving at the percentage share of each state, it took the figures of population of 1971 Census and

the average of assessments made during the five years ending with 1972-73.

This Commission fixed the share of Union territories at 1.79 per cent of the proceeds of income tax in each financial year on the basis of the same principles as applied to the States in determining their share.

Union Excise Duties

In making its recommendations with regard to the distribution of these duties between the Union and the states and among the states themselves, the Commission took a number of factors into account. In the first place, it struck a balance between the plan of the states for a substantial increase in the divisible pool andthe needs of the Centre. Secondly, it had also to ensure equity in the aggregate transfer of resources as between 'surplus' and 'deficit' states since an enlargement of the divisible pool would confer disproportionately larger benefits on surplus than on deficit States. On the basis of these considerations, it retained the states' share of all basic duties of excise at 20 per cent during the period covered by its award. It also recommended that 20 per cent of the net proceeds of auxiliary duties of excise be distributed among the states from 1976-77* onwards. The levy of regulatory duties of excise had been replaced under the Finance Act of 1973 by auxiliary duties on excisable goods and the Finance Act specifically laid down that these auxiliary duties were levied for purposes of the Union and their proceeds were not to be distributed among the states.

The Finance Commission, however, felt that the levy of excise duties on a non-sharable basis should be confined to short periods of two to three years at the utmost to meet the large demands on national exchequer that may unexpectedly arise. Therefore, it recommended that these duties be made sharable from 1976-77 onwards to meet the pressing needs of the Centre in the immediate future and at the same time to allay the apprehensions of the States that these duties were being resorted to in order to deprive them of their legitimate share in the growth of revenues from Union excise duties.

As regards the distribution of the net proceeds of Union excises among the states, the Commission agreed with the earlier

Commissions that contribution or collection would not be an appropriate basis for distribution and it recommended that the two criteria which had gained general acceptance with the earlier Commissions were population and relative social economic backwardness of the states. The Commission argued that the objective of rectifying, to the extent possible, regional imbalances should be recognised as a distinct criterion in determining the principles of fiscal transfers in any federation. In assessing the relative backwardness of states, the Commission considered per capita income as the best, possible yardstick for the measurement of the levels of development. The States, on the other hand, had put forward a number of other criteria for measurement of relative backwardness which the Commission was unable to accept.

The Commission raised the weightage of backwardness from 20 per cent to 25 per cent, the *inter se* distribution of this portion of the excise duties to be in relation to the 'distance' of a state's per capita income from that of the state with the highest per capita income multiplied by the population of the state concerned according to the Census of 1971. The balance of 75 per cent of the states' share of the divisible pool of Union excise duties was recommended by it to be distributed on the basis of the population of the States concerned according to the Census of 1971.

Additional Duties of Excise

The sixth Finance Commission adopted an entirely different approach in this regard. The earlier Commissions had set apart the guaranteed amount and the balance of revenues had been distributed among the states on the basis of certain defined principles. The sixth Commission, however, adopted the approach that entire net proceeds should be distributed among the states on the basis of certain principles. The earlier Commissions had perhaps felt that unless the guaranteed amounts were first set apart and the balance alone distributed among the states, there was the risk of the share of some of the States falling short of the guaranteed amount. The sixth Commission on the other hand, was convinced that there was absolutely no risk of the share of some of the states falling short of the guaranteed

amount, because the expected net proceeds of additional excise duties during the forecast period after excluding the share attributable to Union territories on the existing basis was estimated at Rs. 1037 crores as against the guaranteed amount of Rs. 32.40 crores per annum or Rs. 162 crores over the same five year period. Thus the guaranteed amount worked out to about 16 per cent of the anticipated distributable part of additional excise duties.

Further this Commission also thought that the initial reservation of guaranteed amounts conferred an unintended advantage on certain states and introduced an avoidable element of distortion in the scheme of distribution of additional excise duties.

As regards the basis of distribution of additional excise duties among the states, the Commission like the earlier ones was of the view that the principle of compensation was the only valid principle in the distribution of additional excise duties. This meant that every state should be enabled to get the equivalent of what it would have secured if it had not surrendered its power to levy sales tax on the commodities in question. The second proposal which was quite incontrovertible was that state-wise figures of consumption of the commodities on which additional excise duties are levied afforded by far the best indication of the potential loss of revenue sustained by their surrender of authority to levy sales tax on them.

The Commission, therefore, examined the available statistics of state-wise consumption of the commodities on which additional excise duties were levied and it found that except in the case of sugar the available consumption figures could not be regarded as providing an equitable and firm basis for distribution of the proceeds of additional excise duties. Therefore it looked for some better indices of consumption of these commodities and came to the conclusion that consumption is directly related to levels of income. Thus the latest available data on state domestic product was considered to provide a broad indication of the likely consumption of these commodities. However, the Commission thought it necessary to recognise that the consumption of tobacco and possibly even of sugar depends apart from levels of income, on the habits of the people, the social mores and other intangible factors. As regards textiles, the varieties

of cloth should be among necessities of life, the consumption of which is more likely to depend on population rather than on state domestic product.

Having regard to these considerations, it felt that population and the average state domestic product for the three years 1967-68 to 1969-70 should be taken together as providing a reasonable basis for assessment of the levels of consumption, consumption being given considerably higher weightage. The Commission, however, took another factor also into account. This was the production of the commodities exported to other states subject to inter-state sales tax. The rate of additional excise duties on these commodities worked out to about 10.8 per cent of the value of clearance. In view of this it felt that while production of these commodities in different states had to be given a measure of weightage, the weightage should be comparatively small in view of the ceiling on rates at which inter-state sales tax can be charged.

Thus, it provided the principle that additional duties of excise be distributed among the states on the basis of population, state domestic product at current prices and production in the ratio of 70 : 20 : 10. On this basis the relative percentage of each state was worked out. On the basis of the same criteria as applied to the share of Union territories was worked out as 1.41 per cent of the net proceeds.

Estate Duty

The sixth Finance Commission endorsed the recommendation of the earlier Commissions that population provided a satisfactory basis for distribution of estate duty in so far as it relates to movable profits. Out of the net proceeds of the estate duty in each financial year, a sum equal to 2.5 per cent was recommended to be retained by the Union as being the proceeds attributable to Union territories. This figure was worked out by taking into account of the population of the Union territories according to the Census of 1971 and the gross value of immovable profits located there and brought into assessment for the five years ending 1971-73. The balance of the sums to be apportioned between immovable and movable profits was determined in the ratio of the gross value of all such properties

brought into assessment in that year and the amount attributable to immovable profits was recommended to be distributed among the states in proportion to the gross value of immovable profits located in each state and brought into assessment in that year. The sum attributable to other profits was to be distributed among the states in proportion to the population of each state.

Grants in lieu of Tax on Railway Passenger Fares

With regard to this question all the states made a vehement plea before the Commission against the grant being frozen at Rs. 16.25 crores per year and urged that the Commission should recommend to the Government of India for enhancement of the grant *pari passu* with the increase in earnings from passenger fares. With regard to the principles of distribution, many of the state governments favoured the continuance of the existing principles without any change. Some of the States, deficient in rail facilities, urged that while distribution of 80 per cent of the grant might be made on the existing principles, the balance of 20 per cent should be distributed among the states whose railway mileage in terms of area was below the all-India average in proportion to the shortfall from such average multiplied by the area of the state concerned.

The Commission examined the pros and cons of the various suggestions put forward by the state governments and came to the conclusion that the principles of distribution of *ad hoc* grant in lieu of the tax should be so designed as to place the states on more or less the same footing as and when the tax was in force, but states in which there are no railways could have no claim to this grant. The principles of distribution of this grant originally formulated by the second Finance Commission had stood the test of time. In the circumstances, the Commission recommended that the allocation of passenger earnings from non-suburban services from each gauge for each railway zone separately among the states according to route length lying within each state would be the most equitable basis for the distribution of this grant.

Further the Commission urged that the Government of India should redetermine the amount of grant payable in lieu of

tax on passenger fares in terms of what the states could have got if the railway passenger tax had continued in its original form. The additional loss to the Centre or gain to the states, as a result of it, would be only of a marginal character, but it would have a significantly favourable impact on Centre-State financial relations. Besides, the Commission also felt that any proposals for the reimposition of the railway passenger tax or enhancement of passenger fares would be justifiable to the extent that such enhancement was linked specifically with the payment of larger grants to the States.

Grant on Account of Wealth Tax on Agricultural Property

With regard to this question, the Commission was of the opinion that wealth tax on agricultural property is comparable in its incidence to estate duty in so far as the latter relates to immovable property. The location of property in each state is clearly identifiable and provides, therefore, a reliable basis for distribution of the proceeds of the tax among the states. The Commission, therefore, recommended that the grant-in-aid to be made available to the states on account of wealth tax on agricultural property should be distributed among them in proportion to the value of agricultural property located in each state and brought into assessment in that year. Population was not regarded as a suitable basis for distribution since it has no bearing on the extent or value of agricultural property brought within the tax net. Collection was also not considered an appropriate basis as the tax collected might in some cases relate to property located outside the state. Backwardness or need for development of any particular area was also not considered relevant in the distribution of the grant.

The Commission estimated that the net amount available for payment to the states as grant-in-aid during the period of its recommendation would be only of the order of Rs. 45 lakhs a year. In view of the relatively low and uncertain yield from this tax, the Commission considered that the grant likely to be made available to the states out of the proceeds of this tax should not be taken into account in assessing the resources of the states for the period of the award. Therefore, the amount was left out of account in computing the non-plan revenue gap

of the states. Accordingly, the grant on account of wealth tax on agricultural property distributed among the states was reckoned as a resource for state plans.

Summary

The recommendations of the Commission, therefore, may be summarised as shown in Table 8.12.

TABLE 8.12

State	*Income-tax (percentage)*	*Union-excise (percent)*	*Additional duties excise percentage*	*Grant in lieu of passenger fares tax (percentage)*	*Estate duty percentage*
Andhra Pradesh	7.76	8.16	8.39	8.01	8.04
Assam	2.54	2.71	2.47	2.70	2.70
Bihar	9.61	11.47	9.36	10.58	10.41
Gujarat	5.55	4.57	5.91	7.47	4.93
Haryana	1.77	1.53	1.94	2.57	1.86
Himachal Pradesh	0.60	0.63	0.59	0.17	0.64
Jammu and Kashmir	0.81	0.90	0.73	0.02	0.85
Karnataka	5.33	5.45	5.62	3.47	5.41
Kerala	3.92	3.86	3.58	1.61	3.94
Madhya Pradesh	7.30	8.15	6.08	8.89	7.70
Maharashtra	11.05	8.58	11.65	8.87	9.31
Manipur	0.18	0.21	0.17	......	0.20
Meghalaya	0.18	0.19	0.17	......	0.19
Nagaland	0.09	0.11	0.08	0.01	0.10
Orissa	3.73	4.06	3.59	2.24	4.05
Punjab	2.75	1.87	2.68	5.06	2.50
Rajasthan	4.50	5.00	4.17	6.59	4.76
Tamil Nadu	7.94	7.43	7.27	5.14	7.61
Tripura	0.27	0.30	0.25	0.02	0.29
Uttar Pradesh	15.23	17.03	16.10	19.85	16 32
West Bengal	8.89	7.79	8.30	5.73	8.19

As a result of the recommendations of the sixth Finance Commission substantially very much larger resources have been transferred to the states in terms of their share in shared taxes. Table 8.13 indicates the resources transferred to the states during four years from 1974-75 to 1977-78 in terms of the sixth

Commission award under the head of shared and assigned taxes.

TABLE 8.13

(Amount in crores of Rs.)

	1974-75	*1975-76*	*1976-77*	*1977-78*	*Total*
Income tax	512.3	734.1	652.2	688.3	2586.9
Estate duty	9.6	8.2	9.6	9.6	37.0
Union excise duties including additional duties of excise	702.5	856.7	1027.4	1091.7	3678.3
Total	1224.4	1599.0	1789.2	1789.6	6302.2

The substantial increase in resources transferred to the states under shared and assigned taxes has imparted a significant elasticity to the revenues of the states. This is indicated by the fact that the states' own tax revenues increased from Rs. 2196.9 crores in 1973-74 to Rs. 4317.5 crores in 1977-78 representing an increase of about 100 per cent in four years. But if the amount of resources transferred under shared taxes be taken into account, the total tax revenues of the states increased from Rs. 3371.6 crores in 1973-74 to Rs. 6111.6 crores in 1977-78 and the amount of resources from shared and assigned taxes contributed about 28 per cent of the total tax revenues of the states in 1977-78. Thus the buoyancy in central tax revenues has increasingly manifested itself in the buoyancy of the States' tax revenues.

An Assessment of the Role of the Finance Commissions

In making an assessment of the role of the Finance Commissions in the formulation of the scheme of devolution of resources in terms of sharable and assigned taxes, it is necessary to take into account a number of considerations. In the first place, the Commissions were restricted and their roles strictly limited in accordance with their terms of reference as laid down in the Presidential orders. But even then, they came

out with various suggestions for the improvement of the Centre-state financial relations. The Commissions were always guided by objective criteria of ensuring the stability of the finances of the Union government while at the same time trying to allocate increasingly larger resources to the states. The Commissions always emphasised the need on the part of the states to tap their resource potentials especially in the rural sector, to realise their tax arrears and to achieve maximum efficiency in general and fiscal administration as well as to develop a suitable machinery for effective formulation and implementation of development plans. While they admitted that the process of planned economic development inevitably led to fiscal centralisation, they were conscious of the increasing erosion of the financial autonomy of the states and the demoralising effects that it caused.

The distribution of the proceeds of shared and assigned taxes among the states cannot be justifiably made on the basis of principles on which grants-in-aid are allocated. The approach of the Finance Commissions, therefore, in allocating the proceeds of these taxes was quite sound. The successive Finance Commissions increased the share of the states in the divisible pool of income tax with the result that their share was fixed at 80 per cent by the sixth Finance Commission. This was done with the objective of increasing the resources of the states and to meet their grievances on account of their being deprived of their share in corporation tax and increasing resort by the Union Government to levy surcharges on income tax exclusively for the purposes of the Union. But the case of the states for a share in the corporation tax is quite strong and the constitution did not make a provision to deprive them of a share in this tax. The sixth Finance Commission was of the view that the inclusion of corporation tax in the list of sharable taxes would not seriously upset the relative balance between the Union and state resources.

But in allocating the proceeds of income tax among the states the weightage assigned to the factor of collection which was later substituted by assessment is not sound. In a national economy, the origin of income is a function of the factors which shape the behaviour of the entire economy and local factors have no importance whatsoever in it. Thus population

alone should be the basis of distribution of the divisible pool income tax among the states.

With regard to the allocation of resources from Union excises, the sixth Finance Commission widened the scope of distributable excises by including excises on all articles excluding auxiliary and special excises. This approach was influenced by the consideration for a devalution of larger resources to the states in order that they may have a greater freedom of action. It was with regard to the distribution of Union excises among the states that the Finance Commissions introduced a weightage in favour of backwardness and the sixth Commission increased the weightage as indicated in terms of the distance between the per capita income of a state from that of the state with the highest per capita income. This approach of the Finance Commissions represented an attempt, through a modest one, to tilt the scale in favour of the relatively less developed states in order to contribute to the reduction in inter-regional imbalances. It must, however, be admitted that its impact in correcting the differences in resources of the states has not been at all of any magnitude.

Similarly in the distribution of the proceeds from additional duties of excise among the states, the sixth Finance Commission introduced a weightage in favour of state domestic product at market prices and this was also an attempt to correct, to a small extent, the inter-regional disparities in resources.

The recommendations of the successive Finance Commissions have progressively increased the resources of the states as a result of which the elasticity in the Central revenues has made its impact on the revenues of the states also. Thus as a result, the proposition, that the resources of the states are much less elastic than those of the Centre, does not stand the test of empirical verification.

But it must be admitted that the approach of the Finance Commission was guided predominantly by practical considerations with a view to achieve equilibrium in state budgets and it was not aimed at bringing about a large redistribution of the national resources in such a way as to correct the disparities in the inter-regional resource levels.

References

1. *Indian Financial Equiry Report* by Sir O. Niemeyer, 1936, p. 4.
2. *ibid.*
3. *The Report of the Finance Commission*, 1952, p. 105.
4. *ibid.*, p. 75.
5. *ibid.*, p. 74.
6. See the Report of the Expert Committee on the Financial Provisions of the Union Constitution, 1947. The Constituent Assembly of India.
7. The Total income assessed for income tax in 1952-53 was Rs 729.60 crores, out of which Rs. 416.12 crores was the income of business including companies, i.e., the income of business and companies constituted 57% of the assessed income tax. The Report of the Taxation Enquiry Commission, Vol. 11, p. 23.
8. *The Report of the Finance Commission*, 1952, pp. 74-75.
9. *ibid.*, p. 76.
10. *ibid.*, p. 82.
11. *Report of the Finance Commission*, 1957, pp. 38-39.
12. *ibid.*, p. 40.
13. *ibid.*, p. 44.
14. *Report of the Third Finance Commission*, 1961, p. 35.
15. *ibid.*

9

CENTRAL GRANTS AND REGIONAL BALANCE IN DEVELOPMENT

Rationale of Grants

In a federal system with its complex economic relationships, it is not found possible to maintain the theoretical condition that each unit of government should raise adequate resources for the administration and performance of functions assigned to it. There develops a disequilibrium and lack of balance between the financial capacity and financial need of the regional governments. Therefore, "the grant is an effective instrument for bridging the gap between fiscal capacity and capacity for administration."[1]

The mechanism of grants also operates to secure another objective of fiscal policy and this is the removal of wide disparities in the standard of social services and social conditions in different States. Through the federal tax collecting and redistributing agency, the financially stronger States contribute through the medium of grants to the development of higher standards of social services in the financially weaker states, and thus, the levels of social services in the economy as a whole are sought to be equalised. "Were it not for the grant-in-aid mechanism, a choice would have to be made of one of several evils: (1) to leave important services without adequate support, thereby permitting the prestige of the States to suffer accordingly or (2) to force the States and localities to extend their revenue systems to include taxes ill-adapted for local tax jurisdictions, thereby introducing inequities and economically unsound elements into the total tax structure or (3) to require the federal government to take over the administration of functions which could more effectively be administered by local officials.

Examined in this light, federal aid to subordinate units can be made a valuable device for preserving local self-government while at the same time raising service standards and effectively utilizing the most desirable tax sources."[2] Therefore, with regard to services which are of national importance, federal aid on the basis of differential or equalisation principle is advanced to bring about fairly uniform standards of social services.

Speaking of the role of federal grants in U.S.A. the Report to the Congress by the Commission on Organisation of the Executive Branch of the Government, 1949, maintains that "The plan of federal grants has developed a division of responsibility —the National Government giving financial aid and establishing board standards, the State government sharing the final burden and maintaining primary responsibility for administration. In addition to decreasing inequalities of service, the grant-in-aid method has raised the level of all aid services without transferring functions entirely to the National Government."[3] The Report of the Commission on Inter-Governmental Relations in USA has pointed out that by the offer of grants-in-aid, the federal government has been providing incentives to the states to take on new functions mainly in the field of social services and this has tended to equalise between poor and rich states.[4]

An important purpose of federal grant to state governments is fiscal with a view to lightening the load borne by the budgets of these governments in their performance. In doing so, the federal government may endeavour to underwrite a national minimum standard in the performance of social services of national importance and to equalise opportunities. In the absence of such a grant, there would be a tremendous financial pressure on the limited resources of the financially weaker states, and as a result, they would be compelled to put an undue reliance on regressive commodity taxes. There may prevail wide differences in technical conditions in different states and by participation in the programme of federal aid, suitable conditions are created and a stimulus is provided for the improvement of technical conditions in the administrative standards of the regional government.

Through the medium of grants, the federal government promotes an interregional redistribution of national income

which it considers desirable from the point of view of welfare consideration and the redistributive ideals of public finance; and through it, an economic development of the backward areas of the country is attempted to be brought about. The system of equalisation grant by the federal government may also succeed in bringing about a redistribution of income between the different income groups in the economy, but the extent to which this objective is secured would also depend on the progressiveness of the tax structure in the economy as a whole. The Federal aid to the regional governments may maintain a high level of economic activity in the context of an impending deflationary gap; and in this way it may operate as an important compensatory device to keep the level of spending by the regional governments high. But in order to secure a counter-cyclical objective, the system of federal grant should be sufficiently flexible so that the quantum of grant may be reduced in a period of inflationary pressure and increased when depression threatens.

The case for federal grant to states also rests on the fact that it can be used to correct the undue concentration and it contributes to a wide diffusion and dispersal of economic activities in the economy. Besides, by promoting the economic expansion of financially deficient areas, it seeks to achieve a better inter-regional balance in economic development, and defended on the ground that it is a necessary concomitant to national plans for maintaining employment at high levels.

A distinction should be made between the stimulative and fiscal effects of the system of grant "because it explains important differences in the philosophy grants."[5] When the federal government is interested in stimulating state performance of a function, it has to specify standards and tests of performance, minimum levels of achievement and matching requirements may be laid down. Thus, the federal government is primarily interested in programming. But where the federal government has primarily a fiscal objective, it is basically interested in maintaining a budgetary equilibrium in the deficient states; though in many cases, it may become difficult to make a sharp distinction between the promotional and fiscal effects of the programme of federal grants.

An importance effect of federal grant is felt in the shape

of a concerted operation and an effective co-ordination of fiscal policy between the different layers of governments.

Federal grants may be (a) general or unconditional, and (b) specific or conditional. The system of unconditional grants has been perfected and practised extensively in Australia and Canada, though unconditional grants in these countries go side by side with specific or conditional grants. In Australia, in the estimate of the quantum of grant to a state, the norm of budgetary standards constitutes the basis on which the fiscal needs of the state is essentially founded. This involves a comparison of the budgetary standards as the norm of fiscal need, allowance is made that a state receiving aid is not extravagant in its expenditure and makes all possible efforts to tap its own resources to the full. Besides, in assessing the fiscal need of a state, the scope that may exist for economics in expenditure and for enlarging the receipts from taxation is also taken into account.

The objective of these grants in Australia is to enable the States to operate their functions at a standard of performance not far below that of those states which do not claim such grants. These grants do not seek to achieve absolute equalisation in standards because a margin is maintained in order that the state may make the utmost effort to exploit its tax potentials to the full and its incentive to continue to do so may not be adversely affected.

In Australia, "special grants are justified when a state through financial stress from any cause is unable to discharge its functions efficiently as a member of the federation and should be determined by the amount of help found necessary to make it possible for that State, by reasonable effort, to function at a standard not appreciably below that of other States."[6]

In Canada and Australia, the conditional and unconditional grants go together. But in USA, the conditional grants constitute the principal method of assistance to states and the federal aid is channelled to extend financial support to particular functions. A particular variant of the system of conditional grant is the system of matching grants where the federal aid is given on the condition that a certain proportion of the finance required for a service is mobilised by the state

itself, the rest being extended by the federal government in the form of grants. The system of matching grant may be directed to achieve equalisation in the standard of performance with regard to specific services if the proportion of grant for a particular service be varied in accordance with the financial capacity of the different states, over-matching being required by the financially stronger states and undermatching the poorer ones.

The system of conditional grants has been subjected to a number of criticisms. In the first place, specific grants may lead to an undue expansion of the aided services at the cost of others unless the total picture of the financial need and financial capacity of each state is kept fully in mind. As Hansen and Perloff have put it : "The effect of singling out a few governmental services or parts of functions for federal aid is to place them in a preferred position in securing state and local appropriations. In fact, the success of a matching grant for a specific service is generally measured by the degree to which it stimulates the recipient units to expand their outlays on the aided service. Within the poorer sections of the country, especially, the extension of federal aid for a limited number of functions tends to bias State and local budgets in the direction of the aided services and from the standpoint of the relative need for the various social services to distort the budgets.'[7]

The system of equalising grants has also its dangers and defects. It requires Central interference for efficient administration which might nullify one of the purposes of the use of grants, which is to maintain local interest, initiative and administration. It also creates a tendency to discourage any adjustment or reorganisation of local units to increase their financial ability or to reduce their needs and consequently, to reduce the amounts of grants received by them. This may result in the freezing of the budgets of the regional governments.

Rationale of Federal Grants in a Developing Economy

In a developing economy, the different regions may be at different levels of economic development. The more

under-developed regions may possess enough potential resources requiring utilisation. Therefore, it has been maintained that aim of federal grants in this context should be directed towards the maximisation of national production through the achievement of regional balance in economic development.

It has been pointed out that lack of regional or geographical balance in economic development is harmful to national development. This may lead to over-investment of capital in one state and under-investment in another. As a consequence of this, there will be low productivity and stagnation of the economy as a whole. It will hinder the continuous flow of resources from less productive to more productive uses and the total national output is restricted in the absence of a balanced growth of different states of a developing country with a federal structure of public finance. The low level of income in the backward regions will not provide a sufficient margin for savings to foster the investment necessary for their development. At the same time, the level of output in the relatively advanced states instead of finding outlets in the low-income areas, will be limited by the level of consumption there. Therefore, their economic development will be hindered because the growth of investment will be retarded as a result of a lack of effective demand.[8] From this point of view, the role of Central grants would be to supplement the investible resources of the States in order to achieve inter-regional equilibrium in economic development.

But it has been also argued that in a developing economy the logic of economic analysis dictates that the resources of the economy should be allocated into different channels of investment in terms of the criterion of highest marginal productivity in order to accelerate the rate of economic development. This may not be compatible with the objective of achieving regional balance in development. The backward regions may not be well-endowed with potentially rich resources waiting to be developed. Thus there may be uneven and marked heterogeneity in the distribution of natural resources among the different regions. The objective of achieving regional balance in development requires the apparatus of public finance to be redistributive in nature, but this may be incompatible with achieving the maximum rate of economic

development.

In a planned economy trying to maximise the rate of economic growth it is necessary that the allocation of resources by the Central planning authorities be guided by the principle of equalising marginal productivities in the different lines of investment. The pattern of investment embodied in the development plan has to be designed in a manner so as to conform to the principle of allocative efficiency. The role of federal grants should also be viewed in a developing economy from the criterion of allocative efficiency and this may not be compatible with the objective of regional balance in development. To the extent that the financially deficient states are richly endowed with potential resources, the Central grants directed towards the development of these resources may conform in some cases to the criterion of allocative efficiency. Therefore, it follows that the planning authorities of a developing country should extend Central financial assistance to only those development projects of the states which conform to the criterion of highest marginal productivity.

But though a conflict is posed between the objective of achieving regional balance and promoting a high rate of economic growth, a developing economy cannot ignore the objective of achieving regional balance in development for a long time because this will be fraught with serious economic and political consequences which have the potential to undermine the foundations of a federal polity and to affect adversely its rate of growth.

Federal Grants in India

In India in the pre-1919 era, grants to provinces were a marked feature of financial adjustment. During the depression of 1930 and after, Central grants to provinces were extended to relieve distress. The Bihar earthquake of 1934 gave an impetus to the provision for financial grants. In the pre-war period, financial grants from the Central Rural Development Fund for financing such schemes as animal husbandry, agricultural research, malaria control and improvement of small-scale industries were made to the provinces. But there was no systematic and well-planned system of federal grants and

the grants made were entirely of the nature of *ad hoc* and stop-gap arrangements.

On the eve of the inauguration of Provincial Autonomy in 1937, Sir Otto Niemeyer recommended the provision of annual Central grants to the provinces of Assam, N.W.F.P., Orissa and Sind in order to set their finances on 'an even keel'. But the Niemeyer Award put "too much emphasis on the need of securing budgetary equilibrium in the provinces. It was concerned more with the immediate, short-range purpose of putting the Constitution of 1935 into effect rather than with considerations of the theory of federal finance. Its basis of fiscal need really amounted to the political need of treasuries to pay their way."[9] The Niemeyer Award treated grants-in-aid as a form of residuary assistance for certain provinces after taking into account the sharing of taxes and the adjustment of debt. While estimating the overall fiscal need of a province, it took note of the differences in administrative needs which, it thought, could not be obliterated by Central assistance on a basis common to all the provinces. It recognised the responsibility of each province to ensure budgetary equilibrium and was anxious to set these provinces which were suffering from chronic budgetary deficits on an even financial keel without endangering the solvency of Central finances. It took an integrated view of the finances of the Centre and the provinces and recognised that any scheme of devolution which sought to help the financially weaker provinces involved subsidisation at the expense of financially stronger provinces. It recognised the differences in the fiscal capacity and fiscal need of the provinces and recommended a certain measure of corrective in the form of debt adjustment, unconditional grants-in-aid either fixed or tapering and in case of jute growing provinces, a larger share of the net proceeds of jute export duty.

The Scheme of Central grant embodied in the Niemeyer Award was continued without alteration till 1947. In the meantine, striking changes had occurred in the financial position of the provinces. The financially strong states gained in financial strength as a result of the war-time prosperity in their finances and they were able to build up considerable budgetary balances in their Reserve Funds. But the financially weak states of Assam and Orissa found their financial position

considerably weakened and they were not able to build up any reserves. Consequently, the difference in the levels of administrative performance among the states was increasingly widened. The entire system of federal grants lacked flexibility and became out of tune with the expanding needs of the states.

The province of Bengal had to face huge financial crisis as a result of the famine of 1943. The province was confronted with a series of unbalanced budgets. Central grants amounting to Rs. 18 crores were extended during the period 1943-46 to help Bengal in tiding over its budgetary difficulties.

After 1943, the problem of food shortage became very acute and this accentuated the growing volume of inflationary forces generated by war-time expenditure. As a result of the recommendations of the Food Grains Policy Committee, the Government of India started the 'Grow-More-Food Campaign, in collaboration with the provinces and grants were made available to them for the extension of irrigation facilities, land clearance and improvement. But the grants were not based on the objective assessment of inter-regional needs but were primarily concerned with the short-term objective of increasing food production. "The underlying principle was to produce the maximum quantity of foodgrains at minimum cost irrespective of regional considerations".

The partition of the country in 1947 imposed great administrative burdens on the provinces of West Bengal and East Punjab and Central grants were made to them in order to help them in meeting their financial difficulties. The total grant to West Bengal from 1947-48 to 1949-50 amounted to Rs. 1.40 crores and to East Punjab from 1947-48 to 1950-51 to Rs. 5.25 crores. But these grants were not based upon an adequate appreciation of the needs of these provinces.

Central Grants to States for Development

In the beginning of post-war planning, Central grant to states for development was provisionally envisaged to be distributed in the ratio of their population, but some weightage was given to the backward states of Assam. N.W.F.P., Orissa and Bengal which with Assam had been affected by the impact of the war in the North-Eastern frontiers. In 1948, following a

review of the development schemes, the basis of the allocation of development grants among states was fundamentally changed. The grants were made contingent upon the states spending from their own resources at least equivalent amounts on specific schemes; though in the case of West Bengal and East Punjab which had been severely affected by partition, and Orissa and Assam which are comparatively less developed, it was agreed that the entire expenditure on approved schemes would be reimbursed by the Centre subject to stated maxims. The grants for Grow-More-Food schemes were limited to 50 per cent of the expenditure incurred in case of other states, and to 66.5 per cent of the expenditure incurred in case of Assam and Orissa.

Though the Central government agreed to over-match the funds mobilized by the poorer States and to under-match those of the funds of backward ones, even this principle was not uniformly applied. This is borne out by the fact that the State of Bihar which is equally backward as Assam and Orissa was not selected for the scheme of over-matching of funds by the Centre.

Under the First Five Year Plan, Central grants to states for development have been both discretionary and statutory ; though the volume of discretionary grants occupied a much larger proportion of the total grants.[1] The discretionary grants for development have been made on the basis of an assessment of the financial needs of the states made by the Planning Commission. The grants as originally estimated were increased substantially in view of the shortfall in the realisation of the targets of revenues from surplus in current revenues and from additional taxation by the States (2) Besides, some of the states have also received Central grants on the basis of the recommendation of the Finance Commission since 1952-53. (3) The States of Saurashtra, Madhya Bharat, Rajasthan and PEPSU were also granted additional financial assistance, over and above that visualised by the Planning Commission and the Finance Commission, under the recommendation of the *Part B* States (Special Assistance) Enquiry Committee, 1953. (4) Central grant of statutory nature estimated at Rs. 4 crores was made to the State of Assam for the financing of a part of the development expenditure on scheduled tribes.

It is apparent that Central financial assistance to states for the financing of their development plans was not geared to the task of correcting inter-state disparities in resources. Among the *Part A* States, the states of Bihar, in spite of being one of the most backward, has received the lowest financial assistance whereas Bombay, the most developed of them all, has received practically an equal amount of assistance to that of the State of Orissa. Among the *Part B* States, the States of Rajasthan and Madhya Pradesh being the most backward of them all, have received the lowest amount of Central financial assistance per capita, while the State of Mysore, being the most developed of them all has received a fairly large amount of it per capita.

Under post-War planning, schemes of development qualifying for the receipt of Central grants had to satisfy the following criteria : (*a*) schemes capable of being put into operation at once, (b) schemes which could generate a high level of employment relatively to expenditure and (*c*) schemes which could increase production in the short period. Thus, in spite of the fact that the Centre agreed to over-match the funds of the less-developed states, these states did not have many schemes in their plan which could conform to the above criteria ; and as a result, they failed to obtain a volume of grants capable of correcting the wide disparities in their resources. This is borne out by the wide disparities in per capita development expenditure undertaken by the States during the period of post-War Planning.

In the case of grants made for Grow-More-Food Schemes, the underlying principle was to produce the maximum quantity of food grains at minimum cost irrespective of regional considerations.

The per capita development grants to the backward states of Assam and Orissa were higher than those made to the other states, but even their the per capita development expenditures of these states were much lower than those of Bombay and West Bengal. The per capita grants to Bihar were slightly higher than those to Bombay, but the grant made to West Bengal was higher than that made to Bihar. Thus, though the system of matching grants favoured the backward states of Assam and Orissa to some extent, it tended to operate harshly

in the case of states like Bihar whose own resources were quite meagre.

Even the ratio of population of the States on the basis of which the development grants were originally distributed was not a satisfactory mechanism of correcting the disparity in their resources. It assumed quite unjustifiably a uniformity in per capita incomes and resources among states in a situation in which wide disparities in this regard existed among them.

The Planning Commission had maintained that "in allocating financial aid from the Centre for the various state plans, care has been taken to meet as far as possible the requirements of the more backward areas"[10], and "in allocating Central assistance to Part B States, their special needs for bringing up the level of administration and social services to that to Part A States have been kept in mind."[11] But in spite of the care taken by the Planning Commission to meet the requirements of the more backward areas, wide disparities in the levels of development remained among the states at the end of the First Five Year Plan. In fact, in the assessment of the financial needs of the States for the implementation of their plans, priority was accorded to schemes which would, "in particular, increase the production of food and raw materials in a relatively short period"[12], and as a result, the scheme of Central financial assistance was not conceived in terms of the equalisation of the resources of the states.

Speaking of the role of federal grants after independence the Report of the Second Finance Commission points out: "After the Niemeyer Award, the perspective changed as a result of independence and the new conception of close financial collaboration between the Union and the states on the basis of a national plan of economic development. It was no longer merely a question of higher or lower standards of administration in the restricted sense. The transition from a police state to a welfare state brought about fundamental changes in the scope of governmental functions and resulted in widening the context of fiscal need. Nevertheless, the basic overall approach of Niemeyer still remains valid; the States and the Union have to balance their budgets within their available resources and the needs of the States, which cannot

be met by devolution of shares of taxes, have to be covered by grants-in-aid.[13]"

The Finance Commission of 1952 and Grants to States

In recommending grants-in-aid from the Centre to the states under the substantive portion of clause (1) of Article 275 of the Constitution, the Finance Commission laid down the following principles : (*a*) budgetary needs, (*b*) tax effort, (*c*) economy in expenditure, (*d*) standard of social services, (*e*) special obligations, and (*f*) broad purposes of national importance.[14]

The Finance Commission maintained that budgetary needs of a state should be estimated by making adjustments in the state budgets, so as to reduce them to a comparable basis, and in doing so allowance has to be made for any abnormal or unusual and non-recurrent items of receipts or expenditure which might vitiate comparison unless they are excluded.

As regards the second principle of "tax effort" for assessing the fiscal need of a State, the Commission maintained that the assessment of fiscal needs must involve "as assessment of the general scope for additional taxation in the states and of their tax effort."[15] It is certainly correct that the effort made by a state in utilising its taxable resources to the maximum possible extent must constitute a basis for the assessment of its fiscal need, because in a state in which the maximum effort has not been made to utilise its taxable resources, the effect of Central assistance, apart from not benefiting the weaker sections of the community, may lead the state to postpone its effort for increasing its own taxation. As a result, Central assistance may go "to receive those who are comparatively well off from the necessity of contributing more to State revenue rather than help to increase public expenditure for the benefit of the general mass of the people."[16]

Thirdly, economy in public expenditure, sound financial management and efficient allocation of its own resources by a state must be taken into account in assessing its financial need, otherwise there would be the likelihood that the amount of Central grant might not be efficiently spent for raising the

standard of administration and social services in the states. As the Commission put it, "if the amount of grants-in-aid were to be merely in proportion to the financial plight of a state, a direct premium might be placed on impecunious policies and a penalty imposed on financial prudence."[17] Thus, Central grants to states must be designed in a way so that they may not produce disincentive effects on the states in utilising their own resources to the fullest possible extent and should not diminish their responsibility to balance their own budget by an efficient allocation of their resources.

Fourthly, the standards of social services in a state may be a criterion for grants-in-aid and "an important purpose of grants-in-aid is to help in equalizing standards of basic social services."[18] Besides, the Commission also maintained that "independently of the budgetary criterion, grants may be given to further any beneficent service of primary importance in regard to which it is in the national interest to assist the less advanced states to go forward."[19]

On comparing the budgetary structure and tax efforts of the states of Assam, Mysore, Orissa, Punjab, Saurashtra, Travancore-Cochin and West Bengal, it was observed that the scale of the grants recommended was based upon the consideration of "the normal budgetary needs of these states."[20] Thus, the Central grants to these states, being based upon the consideration of meeting their normal budgetary needs, could not be expected to contribute to the correction of wide disparities in the resources available to the different states.

In addition, the Commission assessed the extent of disparity existing among the states as regards the spread of primary education ; and it recommended grants-in-aid to the eight states most backward in this regard for making a modest beginning in the direction of helping them to make up the leeway with regard to the spread of primary education.[21] But as the Central grants to the backward states were limited to the purpose of making up the leeway only with regard to the spread of primary education, there remained wide disparities in the resources available to the states, and even this grant was diverted to other purposes as indicated by the sixth Finance Commission and as a result the objective of making up the leeway with regard to primary education in the backward

States was not realised.

The Finance Commission, 1957 and Grants to States

The second Finance Commission did not depart in its approach to the problem of federal grant from the basic principle laid down by the first Finance Commission, although its emphasis on these principles was influenced by the development which had taken place subsequently. The Commission endorsed the principle of fiscal need and it interpreted fiscal need comprehensively by taking into account the impact of the completion of the first Five-Year Plan and the needs of the Second Plan. It took an integrated view of the finances of the Union and the states and financial capacity of the Union to assist the states, after meeting its own essential commitments. Therefore, it sought to formulate a scheme of grants-in-aid which should, under normal conditions, enable the states to balance their budgets after meeting their normal revenue expenditure as well as the revenue expenditure incidental to the execution of the Second Five-Year Plan. In estimating the fiscal need and fiscal capacity of the states, the Commission reduced the state budgets to a comparable basis and it also made allowance for the various factors by which the computation or budgetary needs has to be adjusted. Besides, the Commission treated grant-in-aid as residuary assistance to the states after taking into account development of revenue in other forms.

The first Finance Commission was of the view that while considering the eligibility of a state for a grant-in-aid and the amount of such aid, due weight should be given to tax effort so that the states which raise adequate resources through taxation are not penalised and no premium is put upon lack of self-help. The second Finance Commission considered the principle of tax effort to be unexceptionable. But the Commission felt that it is only in clear cases of inadequate taxation that it should affect the quantum of assistance which the states may be otherwise qualified to get. But it maintained that "clear cases of inadequate taxation are difficult to determine. Low per capita taxation in poor States may simply be evidence of low taxable capacity. An agricultural state with a low level of purchasing power has to maintain a comparatively

high level of per capita expenditure to sustain reasonable standard of public services. An industrial State can raise a much larger per capita revenue than an agricultural state, even though the kinds and rates of taxes are the same in both. It is, therefore, difficult to decide whether a state is taxing its people adequately in relation to their income and taxable capacity. Some kind of empirical judgment is inevitable."[22] But the Commission, in its assessment of the tax effort of a state assumed that if a state raised additional revenue which it has promised for the plan, it will have done its part.

An important consideration which weighed with the Finance Commission was the function of grants in reducing inequalities in the standards of basic social services in the states. The second Finance Commission recognised that maintenance of certain important services at a minimum national level may justify giving special grants-in-aid. But it felt that this could be achieved only by stages since total resources are limited. This view of the Commission appears to be quite in conformity with the criterion which has been adopted with regard to the allocation of resources in a developing economy where the consideration of allocative efficiency should be the dominant criterion in this regard. The Commission, therefore, did not recommend special grants for the equalisation of the standards of social services and it left it to the Planning Commission and the National Development Council to ensure the equalisation as far as practicable, of the standard of essential social services in the various states and the Finance Commission has accepted the Five-Year Plan formulated by the Planning Commission and approved by the National Development Council as ensuring an equitable development in the field of social services. The Finance Commission has adopted a correct attitude and approach in this regard, because it is for the planning authorities of a developing country to build up a pattern of investment in the development plan and to allocate the national resources according to the potentialities of development in the various regions of the national economy. But it is necessary for the planning authorities of a developing country to allocate the national resources in order to maximise the rate of economic growth and this may not be compatible with the equalization of the rate of growth in the different states in the initial phase

of planned economic development.

Therefore, the Commission recommended the following principles which should govern the extension of federal grants to states :

(1) "The eligibility of a state to grants-in-aid and the amount of such aid should depend upon its fiscal need in a comprehensive sense. In a Union, in which the Centre and the states co-operate for planned development, grants-in-aid should subserve this end. Properties and provisions in the plan itself should determine the fiscal needs for development for the period of the plan.

(2) The gap between the ordinary revenue of a state and its normal inescapable expenditure should as far as possible be met by sharing of taxes ; grants-in-aid should be largely a residuary form of assistance given in the form of general and unconditional grants.

(3) Grants for broad purposes may also be given. While they last, they should be grants-in-aid of revenues, but the states would be under an obligation to spend the whole amount in furtherance of the broad purposes indicated. Where these purposes are provided for in a comprehensive plan, there will be no scope for such grants."

The principles adopted by the Finance Commission for the determination and allocation of federal grants from states to states appear to be unexceptionable in the context of a programme of planned economic development. But the federal grants recommended to the states of Andhra Pradesh, Assam, Bihar, Kerala, Madhya Pradesh, Mysore, Orissa, Punjab, Rajasthan, West Bengal and Jammu and Kashmir in order to achieve an equilibrium between their budgetary resources and fiscal need appear to have ignored the relative tax efforts of these states in fulfilling the target of resource mobilization from additional measures of taxation. The Commission had accepted the criterion of the adequacy of tax effort as consisting in the fulfilment of the targets of additional taxation as laid down in the plan. But during the First Plan, except Assam, Bombay and Rajasthan, all the other states had substantial shortfalls in the realisation of the plan targets of additional taxation. Besides, as the Commission has itself accepted, there were large accumulated arrears of revenue

collections in most of the states. Thus, if in the context of an inadequacy of tax effort and large accumulated arrears of revenue collections which are an index of the lack of efficiency and urgency in resource mobilisation, Central grants are made to make up the deficiency in the resources of the states in order to help them in achieving budgetary equilibrium, it virtually amounts to underwriting by the Centre of fiscal equilibrium in the states. From the political point of view, such a policy may very well be defended. But it has the danger of weakening the incentive of the deficient states in making the utmost efforts to mobilise resources, to achieve economies in administrative and non-developmental expenditure and to gear their administrative machinery to the collection of accumulated areas of revenues. The Commission has given a preponderating weight to the problem of achieving fiscal equilibrium in the budgets of the states influenced largely by political considerations and it has not given due importance to the fiscal performance of the states, which should be an important consideration in the determination of the quantum of federal grant to a state. Such a system of federal grant would tend to put a premium on inefficiency and would produce a disincentive effect on the fiscal efficiency of the states whose fiscal performance has been better.

The general approach that the Finance Commission has adopted is to regard federal grants as a residuary element in order to achieve an equilibrium in the revenue account and after considering the effects of the devolution of additional resources from shared taxes and efforts of the states to raise additional resources as laid down in the Second Pan. But the estimates of the Commission would prove erroneous as most of the states are bound to show substantial shortfalls in the realisation of the targets of additional resources on revenue account as laid down in the Second Plan.

As the Commission put it, "its main objective has been to ensure that the states have sufficient revenues to meet normal expenditure and their commitments in respect of the plan expenditure on revenue account."[24] For arriving at a reasonable level of normal expenditure, certain adjustments were made by the Commission to secure uniformity in classification. In this estimate of fiscal needs on revenue account, all items of

a capital nature, payments from revenue account, payments from revenue towards the capital cost of the abolition of *zamindari* (interests on the capital cost of *zamindari* abolition have been allowed as a legi- timate charge on revenue and allowance was made for them), sums for amortisation of debt, transfers to special funds for financing capital outlay, expenditure on revenue account to unify the taxation laws in the reorganised states, and the cost of any extension of prohibition were excluded from the expenditure of the states on revenue account.

As regards plan expenditure and the revenue expected to be raised for it from new taxation, the point arose whether the Commission should confine its recommendations to the four years 1957-58 and 1960-61, the remaining period of the Second Plan. The Commission ultimately decided that its recommendations should cover a five-year period; and it took the revenue expenditure of the Second Plan as agreed to between the Planning Commission and the states as the development expenditure on revenue account for the five years ending 1961-62. On this basis, the Finance Commission estimated the development expenditure of the states on revenue account for this period at Rs. 709 crores and it assumed that the revenues to be raised by the states and the specific grants to be made to them by the Union during this Five-Year period would be of the same order and on the same pattern as in the Second Five-Year Plan. This estimate of the Commission suffers from two basic shortcomings. Firstly, the development expenditure on revenue account during the period would be of a higher magnitude because the development expenditure during the Third Plan is expected to be higher than that under the Second Plan. Secondly, the assumption that the states would raise resources from new taxation as contemplated in the Second Plan is not correct because the states are expected to develop a large shortfall in this regard.

Thus in the scheme of devaluation of revenues recommended by the Finance Commission, an attempt was made to provide for both the normal expenditure of the states on revenue account and their needs for implementing the Five-Year Plan to the extent to which the expenditure has to be met from revenue. The Commission tried to meet the requirements of

the states by giving them shares of taxes. But devolution of revenues from shared taxes on a basis common for all the states fell far short of the total needs of most of the states and this deficiency was made good by grants-in-aid.

The grants-in-aid recommended by the Commission were much larger than those paid to the states in the past. This was mainly due to the fact that in the past, the requirements of states for development were not fully taken into account, but the second Finance Commission took them into consideration. The estimate of development expenditure on revenue account for five years ending 31st March, 1962 would throw a net burden of Rs. 228 crores on the state revenues. The Commission estimated the total development expenditure on revenue account for the five-year period at Rs. 709 crores, of which Rs. 206 crores was to be financed through additional revenue to be raised by the states, Rs. 275 crores through expected Central grants and the remaining Rs. 228 crores would be the net burden on the revenues of the states. The Commission assumed that the devolution of revenues proposed by it to the states would enable them to implement the plan assuming that the states raised the additional revenue expected of them during the plan by securing all possible economies in administrative expenditure, by maximising their revenue through the tightening up of the machinery for collection and by the recovery of overdue arrears. But this assumption of the Commission proved to be incorrect; what turned out was a much larger deficit in the resources of the states which was covered by Central grants on an increased scale.

One important fact which the Commission ignored was the fiscal performance of the states as regards their tax efforts in the assessment of fiscal need and the estimate of the quantum of grants-in-aid.

The Third Finance Commission and Grants-in-Aid

This Commission was required to make recommendations in regard to states which were in need of assistance by way of grants-in-aid of their revenue and the sums to be paid to those states other than the sums specified in the proviso to clause (1) of Article 275 of the Constitution having regard, among

considerations, to the requirements of the Third Five-Year Plan and the efforts to be made by those states to raise additional resources from the revenues available to them.

The third Finance Commission fully subscribed to the views adopted by the first and second Commission that the properties and provisions in the Plan itself should determine the fiscal needs for development for the period of the Plan and thus grants-in-aid should subserve the requirements of planned development. But the question arose as to whether the Commission should give full coverage to the estimated revenue component of the Plan or should limit it on practical and other considerations. Two points of view were presented before the Commission on this question. The first was that the Plan itself was flexible and subject to adjustments at the annual reviews, and therefore, there was the need to ensure that the states conformed to the priorities and provisions laid down. If, therefore, full financial allocation was made by the Finance Commission, these reviews would be rendered difficult. The other point of view was that the Plan having been endorsed by the National Development Council and approved by the Parliament, it was only logical to guarantee the necessary resources to the states to enable them to forge ahead. In this regard it was suggested to it that devolution and grants-in-aid by the Finance Commission would be more in tune with the provisions of the Constitution and that it would inculcate a greater sense of responsibility in the states as the grants-in-aid would then become an integral part of their resources.

Though these considerations were of a conflicting nature, the Commission was of the opinion that the states must be provided with the necessary flexibility and room for adjustment with regard to the grants made to them and that undue restrictions and conditions should not be attached to them. Therefore, it was arbitrary to draw a line between the Plan and non-Plan expenditure of a state for a number of reasons. Firstly, a high proportion of what is classified as non-Plan expenditure was itself due to projects launched in previous plan periods for which maintenance and upkeep become a non-Plan liability of the state. Secondly, it was quite logical to regard the entire revenue budget of a state—whether Plan, or non-Plan

—as an integral whole.

Thus the Commission took an integrated view of the plan and non-Plan expenditure of a state in devising the devolution of grants-in-aid to it and it recommended that the total amount of grants-in-aid should be of an order which would enable the states, alongwith any surplus out of the devolution, to cover 75 per cent of the revenue component of the Plan. In determining the revenue component, the Commission deducted in full the amount of additional tax to be raised by each state as incorporated in the Plan itself. The Commission was also influenced in this regard by the fact that the Plan contains repetitive schemes of continuing character and the expenditure on them is unavoidable and is of the nature of committed expenditure.

Thus, in making recommendations for grants-in-aid to states, the Commission took two objectives into account; firstly, to secure the observance of the priorities of the Plan in regard to programmes of national importance and secondly, to encourage and enable the state governments to plan their affairs on a sounder and realistic financial basis and to discourage demoralisation which a dependence inevitably breeds.

Therefore, it recommended the following grants-in-aid in each of the four years 1962-66 to cover budgetary gaps where needed and 75 per cent of the revenue component of the Plan. The assistance towards the Plan made available in the scheme of devolution and grants-in-aid in each of these years is indicated in Table 9.1:

But the Government of India did not accept the recommendation of the third Commission regarding the amount of assistance to meet 75 per cent of the revenue component of the state Plans.

Further, the Commission recommended a grant of Rs. 36 crores for the improvement of communications in the interest of the national economy and national integration. In doing so, it took into account the fact that there was pressing need to open up backward areas, to break down barriers of isolation and stagnation, to develop social services, to mobilise economic resources and above all, to bring about a feeling of oneness in the minds of the people of these regions with the rest of the community. The amount of Rs. 36 crores was

estimated to be about 20 per cent of the proceeds of the duty on under spirit. The allocations to the following ten States (Table 9.2) were made keeping in view the relative needs of the different states and the resources available to them :

TABLE 9.1

(*Rupees in Crores*)

States	*Grants-in-aid*	*Assistance towards Plan included in devolution and grants-in-aid in column 2.*
Andhra Pradesh	12.00	3.00
Assam	9.00	3.75
Bihar	8.00	8.00
Gujarat	9.50	5.25
Jammu and Kashmir	3.25	1.75
Kerala	8.50	3.00
Madhya Pradesh	6 25	5.00
Madras	8.00	5.00
Maharashtra	---	6.75
Mysore	7.75	1.50
Orissa	16.00	4.50
Punjab	2.75	2.75
Rajasthan	8.75	4.25
Uttar Pradesh	12.00	8.00
West Bengal	8.50	8.50

The third Commission's recommendations with regard to the allocation of grants-in-aid to states marked an improvement over the existing position in many respects. Firstly, it took an integrated view of the expenditure and resource position of the states in the context of the process of planned development and regarded the increasing financial burden on the states as a continuous process, the assets built up in course of one plan give rise to the continuing expenditure on their upkeep and maintenance, which, therefore, becomes a committed expenditure. Any distinction between Plan expenditure and non-Plan expenditure was rightly regarded by it as artificial and arbitrary. But the Commission was not guided by the objective of promoting regional balance in its schemes of allocation of grants-in-aid to the states. The achievement of budgetary equilibrium in the context of a programme, of planned development was the supreme objective of the Commission in

this regard. Therefore, it follows that since the Planning Commission had formulated the State Plans to maximise the rate of growth of the economy as a whole, the role of the Finance Commission in assuming the State Plans as the basis of their fiscal exercise in resource allocation necessarily perpetuated the inter-regional imbalances in levels of development and the standard of basic social and administrative services. But the Commission in making an earmarked grant for the improvement of communications in some of the relatively backward states did make a beginning in the direction of shifting the pattern of resource allocation towards the correction of inter-regional imbalance in the case of the development of a very important infrastructural facilities, i.e., communications. But even this limited objective was not realised since the money allocated to the states for this purpose was diverted to other uses as the Sixth Finance Commission later indicated. The Third Finance Commission, therefore, should have provided for effective safeguards in the light of the experience of the grant recommended by the first Finance Commission to make up the deficiency with regard to primary education which was also diverted to other uses by the backward states.

TABLE 9.2

(In crores of Rs)

State	*Per Year*	*Total for four Years 1962-66*
Andhra Pradesh	0.50	2.00
Assam	0.76	3.00
Bihar	0.75	3.00
Gujarat	1.00	4.00
Jammu and Kashmir	0.50	2.00
Kerala	0.75	3.00
M.P.	1.75	7.00
Mysore	0.50	2.00
Orissa	1.75	7.00
Rajasthan	0.75	3.00

Grant-in-Aid and the Fourth Finance Commission

The Fourth Finance Commission, confined itself to non-Plan revenue expenditure *vis-a-vis* the revenue receipts anticipated

in the coming five-year period on the basis of taxation levels in 1965-66, as it did not deem it appropriate to deal with the states' new plan expenditure because the Planning Commission had been specially constituted to advise the Government of India and the State governments in this regard. They therefore, did not recommend grants for meeting the gap in the revenue component of the Plan. On the other hand, included in the estimates of expenditure, the requirements of the states for payment of annual interest on loans outstanding and those likely to be raised in the Fourth Plan as well as provision for contribution to sinking funds for public loans. After assessing revenue receipt and non-Plan expenditure of different states for 1966-67 to 1970-71 and the amounts accruing to them as their share of the various taxes and duties, ten states were found to have revenue deficits aggregating Rs. 609.45 crores for the financial years 1966-67 to 1970-71 and the Commission recommended annual grants, under Article 275 of the Constitution, amounting to Rs 121.89 crores, equal to one-fifth of the deficit.

TABLE 9.3

States	*Interest liability in respect of loans outstanding at the end of the Third Plan*	*Interest liability in respect of loans likely to be raised in the Fourth Plan*	*Sinking Fund Provision (including 4th Plan Loans)*
Andhra Pradesh	76. 95	43.18	4.94
Assam	30.20	16.10	11.19
Bihar	86.08	41.31	9.04
Gujarat	50.81	25.30	28.41
Jammu and Kashmir	20.14	8.90	--
Kerala	40.48	22 00	3.63
Madhya Pradesh	73.53	37.97	7.19
Madras	79.13	41.61	8.90
Maharashtra	97.81	51.15	46 85
Mysore	58.66	29.92	15.00
Orissa	62.37	31.58	31.49
Punjab	75.53	29.99	12.15
Rajasthan	58.01	29.46	16.90
Uttar Pradesh	104.21	68.38	61.97
West Bengal	73.73	45.14	28.56
Total	987.64	522.29	286.27

The Commission had excluded from its assessment of revenue expenditure certain increases in pay scales and dearness allowance to State government employees and employers of local bodies and school teachers effected by the State governments of Andhra Pradesh, Mysore and Uttar Pradesh through orders issued in July 1965. The Commission had recommended that the effect of these liabilities might also be taken into account in fixing the grants under Article 275 of the Constitution. As a result the grants recommended by the Commission for Andhra Pradesh and Mysore were increased by Rs 6.29 crores and Rs 2.58 crores, respectively, during each of the years from 1st April 1966 to 31st March 1971. Uttar Pradesh also qualified for a grant of Rs 9.85 crores during each of these years.

TABLE 9.4
Grants to States

(Rs Crores)

States	*District (5 times annual grant)*
Andhra Pradesh	36.10
Assam	82.60
Jammu and Kashmir	32.85
Kerala	104.10
Madhya Pradesh	13.50
Madras	34.20
Mysore	91.20
Nagaland	35.35
Orissa	145.90
Rajasthan	33.65
Total	609.45

The Third Finance Commission, it may be recalled, had recommended payment to certain states of a sum of Rs 36 crores (or Rs 9 crores per year for a period of 4 years) as a special purpose grant for improvement of road communications. The Fourth Finance Commission was not in favour of any separate special purpose grants.

Grants-in-Aid and the Fifth Finance Commission

In making its recommendations, the Commission was

required to take into consideration, *inter alia*, (*a*) revenue resources of states at 1968-69 rates of taxation for the five years 1969-70 to 1973-74, (*b*) revenue requirements of states to meet expenditure on administration, interest charges, maintenance expenditure on completed Plan schemes, and (*c*) also the scope for better fiscal management and economy consistent with efficiency which may be effected in State's expenditure.

In the forecasts of revenue receipts and expenditure submitted to the Finance Commission, the State governments estimated aggregate budgetary deficits (to be covered by devolution of taxes and grants) to be of the order of Rs 7,368 crores in five years 1969-70 to 1973-74. The Commission felt that in considering the question of grants, the emphasis must significantly shift from budgetary needs to broad fiscal needs as suggested by the Second Finance Commission. For the purpose of assessing the needs of each state meeting revenue expenditure, the states' estimates were scrutinised by the Commission. While assessing the needs of states, the Commission segregated items like (*i*) working expenses and receipts in respect of departmental commercial schemes, (*ii*) receipts of interest and dividends, and (*iii*) interest payments and amortisation charges for separate assessment; the Commission in estimating major items of receipts and expenditure adopted suitable rates of growth on the basis of past trends, future scope and other relevant matters as explained by the states.

In assessing the revenue resources of states the Commission took full credit for interest due from State Electricity Boards. In the case of Assam and Rajasthan credit was taken only for half the interest due in view of the high operating costs in these states. The Commission assumed that tax arrears in states over a stipulated level would be realised during the period 1969-70 to 1973-74. The Commission allowed expenditure on account of existing schemes of food subsidies for rural electrification schemes but disallowed fresh expenditure in future arising out of enlargement of the scope of these subsidies. In regard to dearness allowances and revision of pay scales, provision was made for implementation of commitments already made but provision for increase in dearness allowance in future was disallowed. The Commission reassessed the requirement of states for meeting the cost of relief expenditure

on account of natural calamities and fixed the average annual amount for the five-year period 1969-70 to 1973-74 at Rs 14.47 crores as against Rs 15.69 crores per annum fixed by the Fourth Finance Commission for the period 1966-67 to 1970-71.

The Commission considered in detail the net expenditure of states on account of interest charges and returns on investments in departmental and other concerns. In general, the Commission did not allow for interest charges on debt to the extent it is covered by corresponding assets in the form of capital outlay on departmental undertakings (like irrigation, road transport, etc), investment in corporations, companies and industrial concerns and loans and advances. The Commission allowed full recovery of interests on loans to State Electricity Boards. In regard to loans to other parties, it assumed the recovery of interest would be at a rate equivalent to the average rate of interest payable by the state on its own borrowings. In the case of capital outlay on multi-purpose river valley schemes and irrigation (commercial), the Commission assumed that within the next five years it would be possible for the State governments to take steps to improve the returns for covering the working expenses and interest at the rate of 2.5 per cent on the investments. As regards other departmental schemes and investments, the Commission assumed that, on the whole, there would be no net loss and that these schemes and investments taken together will yield returns and dividends which would at least cover interest charges on the capital employed. In respect of interest on the loans which are not covered by assets in the form of loans to other parties or investment in commercial schemes, the Commission allowed the amount limited to a maximum of 50 per cent of the States' own revenues as assessed by the Commission. The Commission, however, disallowed provision for interest on *ad hoc* loans from Central Government for clearing overdrafts with the Reserve Bank of India. The principles enumerated above were applied both to interest on debt outstanding at the end of 1968-69 as well as to interest on fresh borrowings during 1969-70 to 1973-74.

In regard to the provision for amortisation of debt there were differences of opinion among the members. The Chairman and one of the members were not in favour of allowing

provision for amortisation. Their views were in accordance with those of the Second and Third Finance Commissions ; these Commissions, it will be recalled were not in favour of making provision for amortisation where such provision was to come out of devolution and grants under Article 275. The other three members of the Commission took the view as did the Fourth Finance Commission, that amortisation provision should be allowed. But whereas the fouth Finance Commission allowed full provision as indicated by states to their forecasts, the amount allowed by the Fifth Finance Commission was limited only to provision in respect of debt (existing as well as fresh) not covered by revenue yielding investments and loans. As against a five-year provision of Rs 1,222 crores made by States in their forecasts for amortisation of loans the Commission allowed, by a majority, provision of Rs 59.66 crores.

TABLE 9.5

(Amount in crores of rupees)

States	*Provision for relief on account of Natural Calamities (Annual Average Provision)*	*Provision for Amortisation or Repayment of Debt (Total for Five-year Period)*
Andhra Pradesh	0.75	1.20
Assam	0.48	3.34
Bihar	1.50	12.02
Gujarat	0.80	0.69
Haryana	1.55	1.73
Jammu and Kashmir	0.40	0.24
Kerala	0.10	4.78
Madhya Pradesh	0.80	9.12
Maharashtra	0.86	1.32
Mysore	0.44	0'78
Nagaland	-----	0.01
Orissa	1.25	4.96
Punjab	0.41	0.37
Rajasthan	1.08	5.68
Tamil Nadu	0.50	1.12
Uttar Pradesh	9.94	2.45
West Bengal	2.61	9.85
Total	14.47	59.66

In respect of states other than those in whose case estimated devolution was expected to result in surplus the requirements of revenue were examined in greater detail. The Commission took into account several factors (in their assessment) such as relative tax effort (in relation to per capita income), levels of revenue expenditure and special factors (such as border areas, proportion of scheduled tribes, sparseness of population, etc.). In the case of some of these states the Commission allowed for a substantially higher level of expenditure (on education and other social services) as compared to other states covered in their scrutiny.

On the basis of the reassessment in the foregoing manner, of the forecasts submitted by the estimated devolution of taxes as well as grant in lieu of tax on railway passenger fares and proceeds of additional excise duties that would accrue to states on the basis of the recommendations embodied in the Report, eight States (Table 9.6) were expected to have surpluses aggregating Rs 1,273.38 crores during the five-year period.

TABLE 9.6

States	*Estimated Surplus (Rs crores)*
Bihar	199.46
Gujarat	158.99
Haryana	79.88
Madhya Pradesh	15.09
Maharashtra	419.29
Mysore	2.58
Punjab	117.22
Uttar Pradesh	280.87
Total	1273.38

Among these states Haryana, Maharashtra and Punjab would, in the Commission's view be having a revenue surplus even without taking into account the recommended devolution of taxes. The Commission has not recommended any grants-in-aid to seven out of the eight States (i.e., except Mysore), under Article 275 of the Constitution. In the case of Mysore, the average amount of devolution of taxes during the five-year period would be less than the average annual amount of devolution and grants which it would have received on the basis

of the recommendation of the fourth Finance Commission. The Commissioner, therefore, considered it desirable to give some further assistance to the state, on a diminishing basis so that it can make suitable adjustments in its financial arrangements. For Mysore and other nine states (Andhra Pradesh, Assam, Jammu and Kashmir, Kerala, Nagaland, Orissa, Rajasthan, Tamil Nadu and West Bengal) which in the Commission's view would be left with revenue deficits after taking into account devolution of taxes, the Commission recommended grants-in-aid under Article 275 of the Constitution, aggregating Rs 637.85 crores for the five-year period 1969-70 to 1973-74.

TABLE 9.7

(Amounts in crores of rupees)

States	*Total of the sum to be paid in five years*	*1969-70 Interim Report*	*1969-70 Final Report*	*1970-71*	*1971-72*	*1972-73*	*1973-74*
Andhra Pradesh	65.01	16.81	15.54	14.27	13.00	11.73	10.47
Assam	101.91	19.90	20.80	20.60	20.39	20.19	1.99
Bihar	21.	3.42	--	--	--	--	--
Gujarat	--	--	--	--	--	--	--
Jammu and Kashmir	73.68	12.02	16.81	15.77	14.74	13.70	12.66
Kerala	49.65	20.82	9.93	9.93	9.93	9.93	9.93
Madhya Pradesh	--	9.36	--	--	--	--	--
Mysore	17.99	20.82	6.48	5.04	3.60	2.16	0.71
Nagaland	77.95	10.88	17.40	16.49	15.59	14.69	13.78
Orissa	104.67	29.18	24.51	22.72	20.94	19.14	17.36
Punjab	--	--	--	--	--	--	--
Rajasthan	51.49	9.67	12.36	11.33	10.30	9.27	8.23
Tamil Nadu	22.82	6.84	6.61	5.59	4.56	3.56	2.52
Uttar Pradesh	--	9.85	--	--	--	--	--
West Bengal	72.62	7.24	22.29	18.41	14.52	10.64	6.76
Total	627.85	176.81	152.73	140.15	127.57	114.99	102.41

The total amount of grants recommended by the fifth Finance Commission in fivs years was less than the amount recommended by the Fourth Finance Commission (703.05 crores for 11 States) for the five-year period 1966-67 to 1970-71. The

Commission specified the amount payable for each year, the quantum diminishing from Rs 152.73 crores in 1969-70 to Rs 102.41 crores in 1973-74. This was a departure from the recommendations of the First, Third and Fourth Finance Commissions which had specified payment of an equated amount in each of the years covered by the respective Commissions. The Second Finance Commission also recommended payment of a uniform amount for each of the years covered by it, except in the case of four States (Assam, Bihar, Orissa, and West Bengal) for which the quantum of grants under Article 273 (grants in lieu of jute export duty).

Grants-in-Aid and the Sixth Finance Commission

The terms of reference of the sixth Finance Commission with regard to grants-in-aid under Article 275 of the constitution were defined to be wider in scope in the presidential order as compared to these issued to the earlier Finance Commissions. It had been asked to make recommendations as to the principles which should govern the grants-in-aid of the revenues of the States and the sums to be had to the States which were in need of assistance by way of grants-in-aid of their revenue having regard, among other considerations, to

(*i*) the existing practice in regard to determination and distribution of Central assistance for financing state plans;

(*ii*) the revenue resources of those states for the five-years ending with the financial year 1978-79 on the basis of the levels of taxation likely to be reached at the end of the financial year 1973-74;

(*iii*) the requirements on revenue account of those states to meet the expenditure on administration taking also into account such provision for emoluments of Government employees, teachers and local body employees as obtaining on a specified date as the Commission deem it proper in the light of the states' capacity and needs, interest charges in respect of their debt, transfer of funds to local bodies and aided institutions and other committed expenditure ;

(*iv*) adequate maintenance and upkeep of capital assets a d

maintenance of Plan schemes completed by the end of 1973-74, the norms, if any on the basis of which specified amounts are allowed for the maintenance of different categories of capital assets being indicated by the Commission;

(*v*) the requirements of States which are backward in standards of general administration for upgrading the administration with a view to bringing it to the levels obtaining in the more advanced States over a period of ten years; and

(*vi*) the scope for better fiscal management and economy consistent with efficiency which may be effected by the States in their administrative maintenance, developmental and other expenditure ;

The Sixth Cammission broadly accepted the approach of the earlier finance Commissions that grants-in-aid of the revenues of the states should be related to their fiscal needs. The Commission, however, considered a close critical scrutiny of the forecasts of receipts and expenditure of State governments for the period covered by its award as an essential first step in the determination of fiscal needs. The Commission adopted specific criteria to reassess the forecasts of revenues and expenditures presented to it by the State governments. In an attempt to enforce fiscal discipline, it assumed reduction of arrears of taxes outstanding to more reasonable limits. It also reassessed the receipts by way of interest on loans advanced to electricity boards, road transport undertakings and third parties according to certain minimum standards considered appropriate by it. In the case of major and medium irrigation projects, it stipulated that at least the charges for maintenance shall be fully covered by the terminal year of its award. Thus, while it made every effort to assure the states adequate resources to maintain budgetary equilibrium, it did not adopt the approach of mechanically filling up of the gap between receipts and expenditure at the existing levels of efficiency in the collection of revenue and management of public enterprises. Its proposals envisaged determined and purposeful efforts on the part of the states at reduction of arrears of taxes and improvement of returns from investments in quasi-commercial and commercial projects.

With regard to the committed liabilities of the states on account of the Plan which the Commission had to take into account in assessing the need for grants-in-aid, the Commission was of the view that unless the normal growth of tax revenue of State governments and returns from commercial projects generated the additional resources to absorb a sizable part of such committed expenditure which resulted from the completion of every five-year plan, the central devolution to cover the same would soon rise to a level at which resources available for sustaining further development would be seriously eroded. This was not considered a healthy trend in federal finance.

The Commission adopted a normative approach also in reassessing the demands of the States for funds for raising emoluments of government employees, teachers in aided institutions and employees of local bodies. These requirements were taken into account in determining the revenue gaps/ surpluses of states. The approach of the Cammission in this regard, therefore, was not only to reward the states for their fiscal prudence but also to bring about, over a period of time a greater measure of equality in levels of scales of pay and other allowances among states.

The Commission also sought to redress to the extent possible, legitimate grievances of the states about inadequacy of funds for maintenance of the existing assets such as buildings, and roads at satisfactory levels. Therefore it made reasonably adequate provision for maintenance of these assets. Further, in order to ensure that the allocations made for the maintenance of these assets particularly irrigation works and roads are utilised for the purpose for which they are intended and that they are not diverted to other uses, it proposed that the provisions allowed by it for maintenance of roads should be assessed together with the outlays to be provided in the Fifth Plan for construction of roads. For purposes of regulating central assistance for the annual plan, it suggested that only the aggregate expenditure on roads in excess of the provisions allowed by it for maintenance should be reckoned as plan expenditure qualifying for assistance. Similar provision was made also with regard to irrigation works. In order to enable the Planning Commission and the Ministry of Finance to apply these checks,

it set out state-wise outlays of the provisions made by it for maintenance of roads, irrigation and flood protection works.

But the most significant departure that the Sixth Finance Commission made from the approach of the earlier Commissions was in the process it initiated for enabling the states which were backward in standards of general administration to come up to a certain national minimum. For this purpose, it identified certain administrative and social services of crucial importance and proposed that the states whose expenditure in per capita terms was below the all States average should be enabled to come up to such an average by the last year of the award of the Commission. Among these services, it considered primary education, medical and public health and welfare of scheduled castes, scheduled tribes and other backward classes to be of crucial importance for the well-being of the people and particularly the weaker sections. In view of the fact that the special grants-in-aid provided by the First Finance Commission for promoting primary education in backward states and the grants provided by the Third Finance Commission for improvement of communications in certain states were not utilised for the purposes for which they were intended, the Sixth Finance Commission thought it essential to devise suitable special safeguards against division of the funds so provided for improvement of these services to other purposes. Therefore, it emphasised the need for effective and purposeful monitoring of the special grants earmarked for administrative upgradation. To this end, it made an important suggestion that the concerned administrative ministry at the Centre and the Planning Commission should, as part of their scrutiny of the annual Plans of the states, take special care to verify whether funds provided by it for primary education, medical and public health and welfare of scheduled castes and tribes and other backward classes were utilised on these services. It further suggested that only such expenditure on these services as was in excess of the provisions indicated by the Commission under these heads should be treated as plan expenditure qualifying for central assistance.

The Commission also examined a few other related questions and made recommendations in regard to them. One such question was the non-Plan grants made by the Centre to the States

such as relief and rehabilitation of displaced persons, relief and other measures necessitated by hostilities, construction and maintenance of border roads, labour and employment, development of border areas, assistance to Jammu and Kashmir for transport of rice and wheat incentive, bonus for higher procurement of foodgrains, modernisation of police force and Central Road Fund. In respect of Central assistance for schemes which were not uniformly applicable to all states, such as payment of bonus for procurement of foodgrains, development of border areas, and construction of roads from the Central Road Fund, the Commission omitted both revenue receipts on account of Government of India's grants to the State governments and the related expenditure in the state forecasts. It recommended that if these schemes were to be continued, the non-plan grants will have also to be continued by the Central Government. As regards the schemes of continuing nature being implemented generally in most of the states, the Commission allowed after necessary secrutiny the non-Plan expenditure of the State governments but the corresponding grant from the Centre was omitted in the reassessment of revenue receipts. In these cases the Central Government was asked not to sanction any non-plan grant as the expenditure on these schemes should be met from the revenues of the States as reassessed by the Commission.

On the basis of the reassessment of revenue receipts and non-Plan revenue expenditure of the states and the principles and general considerations already mentioned and after setting off the resources estimated to accrue to them from devolution of taxes and duties, the surpluses and deficits of the State governments during the five year period 1974-79 were estimated and the following amounts of grants-in-aid were recommended as shown in Table 9.8.

A Critical Assessment

An assessment of the grants-in-aid recommended by the successive Finance Commissions shows that the predominant consideration which guided them in this regard was to help the states achieve budgetary equilibrium. This is why the basic norm adopted for the allocation and determination of the

amount of grant-in-aid to a state was its fiscal needs. The concept of fiscal needs, however, tended to undergo a change progressively with the successive Finance Commissions. But the dichotomy between the fiscal need to finance the Five-Year Plans and that to finance the non-Plan expenditure tended to persist. The Third Finance Commission had made an integrated assessment of the Fiscal needs of the states both on account of the need to finance the Plan and the non-Plan expenditure and recommended grants-in-aid to finance 75 per cent of the revenue component of the Plan expenditure but this recommendation was not accepted by the Union Government. Thus two bodies have been making an assessment of the fiscal needs of the states ; the Finance Commission have been making the assessment of non-Plan fiscal needs while the Planning Commission has been making an assessment of the plan needs of the states. This kind of approach is neither scientific nor logical nor satisfactory.

TABLE 9.8

(*Rs Crores*)

States	*Total amount to be paid in five years*	*1974-75*	*1975-76*	*1976-77*	*1977-78*	*1978-79*
Andhra Pradesh	205.93	42.83	43.47	41.89	39.45	38.29
Assam	254.53	49.66	51.33	50 60	51.35	51.59
Bihar	106.29	18.78	23.92	21.12	21.53	20.93
Himachal Pradesh	160.96	31.72	32.02	32.15	32.42	32.65
Jammu & Kashmir	173.49	34.57	34.65	34.73	34.83	34.71
Kerala	208.93	43 85	43.46	41.19	40.92	39.51
Manipur	114.53	21.05	21.97	22.85	23.84	24.82
Meghalaya	74.67	13 61	14.23	14.90	15.63	16.30
Nagaland	128.84	23.77	24.68	25.72	26.77	27.90
Orissa	304.73	56.97	60.11	61.00	62.56	64.09
Rajasthan	230.53	49.30	48.57	46.05	44.30	42.31
Tripura	112.50	20.66	21.53	22.44	23.45	24.42
Uttar Pradesh	198.83	21.61	33.91	39.23	49.10	54.98
West Bengal	234.86	53.29	49.27	46.57	44 55	41.18
Total	2509.61	481.67	503.12	500.44	510.70	513.68

The fiscal needs of states on account of non-Plan expenditure

have been assessed by the Finance Commissions in terms of their projections of the grants of revenue resources and expenditures built up on the basis of certain normative rates of growth. But the norms evolved were based upon various assumptions which were not fulfilled with the result that the projections widely diverged from the actual developments. Thus the assessments of the fiscal needs of the states by the Finance Commissions have in most cases gone astray. But the Finance Commissions tried to do full justice to the states in taking a comprehensive view of their non-Plan fiscal needs. It is, however, to be remembered that the role of the Commissions has been strictly limited in view of the terms of reference defined in the President's orders. As a result the concept of fiscal need adopted by the Finance Commission was not envisaged in terms of filling up the gaps of unevennes between the states but in terms of filling up the gaps in their non-Plan budgets and so the role of the grants-in-aid recommended by the Finance Commission was of a limited nature.

The Sixth Finance Commission made a significant departure in recommending grants-in-aid for the equalisation of the standards of some of the basic services among the states. But it is worth enquiring if the states have made effective use of the resources transferred to them in this regard and if their standards of basic administrative services have tended to be equalised and the disparities narrowed down. Table 9.9 indicates the per capita expenditures of the states on various items in 1977-78 in terms of their population in 1971.

The figures in Table 9.9 are quite revealing. Some of the states such as Himachal Pradesh, Jammu and Kashmir, Manipur, Meghalaya, Nagaland, Sikkim and Tripura are a class apart and some of them are newly formed states in which the per capita expenditure is higher than the all-India average because of their large dependence on Central grants. These states had very gross deficiencies in the basic administrative services which are, therefore, being developed as a result of a larger per capita expenditure sustained largely by Central assistance. But even among these states, there are large disparities in per capita expenditures. Bihar has the lowest per capita expenditure so much so that the ratio between per capita expenditure of Bihar and Punjab is 1:3 and in the case of health and medical

services, the ratio between these states of per capita expenditure is about 1:4, in the case of education it is 1:2. In the case of Bihar and Maharashtra, also these disparities are large.

TABLE 9.9

States	*Per capita expenditure*	*Per capita development expenditure*	*Per capita expenditure on education*	*(In Rupees) Per capita expenditure on medical, public health etc.*
Andhra Pradesh	211.5	164.1	36.4	19.1
Assam	173.3	123.8	33.3	14.6
Bihar	109.4	79.8	20.3	8.8
Gujarat	222.8	163.7	44.7	21.2
Haryana	302.9	236.1	40.2	22.1
Himachal Pradesh	363.0	281.0	75.0	34.4
Jammu and Kashmir	500.4	377.5	56.0	49.4
Karnataka	231.6	174.0	45.3	18.3
Kerala	235.2	180.0	73.1	26.0
Madhya Pradesh	178.2	133.0	30.0	16.6
Maharashtra	262.4	184.6	44.0	21.6
Manipur	559.5	400.0	78.0	31.0
Meghalaya	451.0	339.0	59.2	52.0
Nagaland	1211.0	849.0	118.4	104.0
Orissa	194.0	144.0	33.8	15.1
Punjab	292.6	227.6	59.0	28.7
Rajasthan	217.0	160.3	40.0	26.1
Sikkim	1013.5	856.0	86.0	81.5
Tamil Nadu	176.3	121.3	39.5	18.1
Tripura	348.2	257.2	65.4	22.9
Uttar Pradesh	150.2	105.1	27.5	9.8
West Bengal (Estimated)	182.0	130.1	34.5	18.5

It follows, therefore, that there are wide differences in the standards of basic administrative services between the different states and the objective of achieving inter-regional balance in development and equalisation of the standards of administrative services among the states still remains a distant goal of national policy.

The way in which the the different Finance Commissions

have approaehed this problem of bringing the administrative standards in the backward states to a minimum level represents largely an *ad hoc* and patch work view of the question. This is well illustrated by the fact that while the first Finance Commission recommended gaants-in-aid to some states to bring the level of primary education to an all-India minimum average. the third Finance Commission recommended grants-in-aid for the development of communications to some of the relatively backward states. But even these grants were not utilised by the states concerned and the money so earmarked was diverted to other uses and so the purpose of these grants was defeated. The sixth Finance Commission did make a wider approach in this regard by recommending grants-in-aid to some states for bringing the standards of some of the basic administrative and social services to a minimum level. But it seems that by the end of 1977-78, the purpose was not achieved as revealed by the figures mentiond above.

It is to be recognised that it is the Five-Year Plan which alone can be an effective instrument to achieve inter-regional balance in economic development. But though the different plans have paid a lip service to the achievment of the objective of regional balance, the technique of planning and the size of the state plans have not been such so as to contribute significantly to the correction of inter-regional imbalances.

The state plans have not contributed to the correction of inter-regional imbalances because of the size of the state plans of the backward states has been smaller due to their limited resources and the Central assistance to states under the Gadgil formula has given a large weightage to population which is not a satisfactory index of backwardness. The assistance should have been allocated in terms of backwardness of states as quantitatively indicated by the distance of a state per capita income of the state with the higher per capita income. Had the resource planning and allocation by the Planning Commission been made on the basis of this principle, considerable progress would have been made by now in correcting inter-regional imbalances.

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10

THE SEVENTH FINANCE COMMISSION RECOMMENDATIONS: A CRITICAL ANALYSIS

Total Resource Devolution to States

The recommendations of the seventh Finance Commission with Justice Shelat as its Chirman mark an important landmark in the field of evolution of new norms governing inter-governmental financial relations in India. The recommendations of the Commission which were accepted by the Government of India with a few and minor exceptions are significant in many aspects. Not only have they involved a devolution of much larger volume of resources to the states, but have given substantial debt relief to them and have evolved definite norms for devolution of discretionary transfers of resources to the States for natural calamities.

The total volume of resource transfers envisaged under the award of the seventh Finance Commission is estimated to be Rs. 23067 crores during the five-year period 1979-84 which apparently seems to be greater by about Rs. 10,000 crores under the sixth Finance Commission award. But a better way to make a comparison of the resources to be transferred under the two awards would be in terms of the resources to be transferred under the seventh Finance Commission and the amount of resources which would have been transferred to the states had the award of the sixth Finance Commission been continued unaltered. The total resource transfers estimated by the sixth Finance Commission over the period 1974-79 amounted to Rs. 10,000 crores, but in fact it turned out to be about Rs. 11,200 crores. If the recent trends in resources were maintained, the continuation of the sixth Finance Commission scheme would have given the states about Rs. 16,150 crores. As against this,

the seventh Commission proposals including debt relief would involve a total transfer estimated at Rs. 23,062 crores. This is very substantial increase indeed.

A breakdown of the resource transfers under the award of the seventh Finance Commission is given in Table 10.1.

TABLE 10.1

(Amount in crores of rupees)

	Rs.
1. Share in income tax	4791
2. Share in Central Excises	11,347
3. Additional Excises	1867
4. Railway fare tax compensation	81
5. Estate duty	64
6. New duty on power	1146
7. General grants	1173
8. Upgradation grants	437
9. Debt relief	2157
Total	23062

In its task of devolution of resources to the states, the Finance Commission is called upon to estimate the non-plan revenue gaps in the finances of the states. After these gaps are estimated, the Commission proceeds first to allocate the tax shares. As a result it is found that some states emerge with surpluses which thev are expected to carry over to their plan budgets. Others which have deficits get grants to fill the estimated gaps. The estimates made by the seventh Finance Commission of the revenues and expenditures of the states have been quite favourable to them, though there are wide differences in the estimates made by the States and the Finance Commission. In general, however, the percentage increases made by the Commission in the States' estimates of their revenues have been smaller than the percentage reductions made by it on the re-assessment of their expenditure. The Commission has found the States' revenue receipts estimates to be more reliable than their estimates of expenditure. Thus, the net result of re-assessment by the Commission is that the non-Plan revenue gaps estimated by the Commission are considerably less than those indicated by the states themselves. The striking thing is that

in some cases the Commission's estimates of the gaps have been less than half or even one-third of the states' estimates and in a few cases deficits have been re-assessed into surpluses.

This is indicated in Table 10.2.

TABLE 10.2

	States	*Surplus or deficit as estimated by State governments*	*Surplus or deficit as reassessed by the Commission*	*Total devolution*	*Surplus or deficit after devolution*	*Statutory Grants*
1.	Andhra Pradesh	−2652	− 580	1503	+ 923	−
2.	Assam	−1113	− 480	497	+ 87	−
3.	Bihar	−3552	−1058	2150	+1092	−
4.	Gujarat	− 842	+ 164	964	+1128	−
5.	Haryana	+ 229	+ 370	309	679	−
6.	Himachal Pradesh	− 489	− 317	110	− 207	207
7.	Jammu & Kashmir	−1010	− 359	159	− 200	200
8.	Karnataka	−1743	+ 1	1005	+1006	−
9.	Kerala	−2621	− 531	766	+ 235	−
10.	Madhya Pradesh	−2072	− 423	1534	+1111	−
11.	Maharashtra	−1376	+1291	1714	+3005	−
12.	Manipur	− 295	− 184	38	− 146	146
13.	Meghalaya	− 246	− 129	36	− 93	93
14.	Nagaland	− 385	− 236	18	− 218	218
15.	Orissa	−1817	− 952	815	− 137	137
16.	Punjab	− 643	+ 390	420	+ 810	−
17.	Rajasthan	−2115	− 663	883	+ 220	−
18.	Sikkim	− 36	− 36	−	− 36	36
19.	Tamil Nadu	−2363	− 849	1479	+ 627	−
20.	Tripura	− 305	− 196	59	− 137	137
21.	Uttar Pradesh	−6211	−1259	3203	1944	−
22.	West Bengal	−3046	− 857	1572	+ 715	−
	Total	−34,338	−9040	19331	+13582	1173
		+ 229	+2216			
		−34,109	−6824			

SOURCE: *Seventh Finance Commission Report.* (Figures for total devolution exclude Rs. 64 crores of Estate duty, the State-wise allocation of which has not been worked out as yet.)

The figures in the above Table are quite revealing. Haryana

was the only state which itself showed a surplus. On the other hand, Maharashtra's own estimate of a deficit of Rs. 1376 crores was transferred into a surplus of Rs. 1291 crores on re-assessment by the Finance Commission making a difference of Rs. 2667 crores. Other States, whose estimates of deficits were similarly transferred into surpluses were Gujarat and Punjab. In the case of Karnataka a deficit of Rs. 1743 crores was converted into a small surplus of Rs. 1.15 crores. In many cases, the large gaps shown by the states resulted from the inclusion of expenditures not properly classifiable as non-Plan, but the point to note here is that such wide divergences between the states' estimates and the assessments by the Commission reflect poorly on the budgeting techniques and the bargaining strategy adopted in this regard by the states.

The Table 10.2 indicates that 21 states estimated a deficit of Rs. 34,338 crores while Table 10.1 showed a surplus of Rs. 229 crores, making a net total deficit of Rs. 34,109 crores. But the Commission's re-assessment has led to a total deficit of Rs. 9040 crores for 17 states and total surpluses of Rs. 2216 crores for five states making a net total gap of Rs. 6824 crores. The tax devolution recommended by the Commission has converted some of the deficits into surpluses and some into reduced deficits, while in the few cases indicated above the estimated surpluses were converted into larger surpluses. The extreme case is that of Maharashtra whose re-assessed surplus of Rs. 1291 crores became a final surplus of Rs. 3005 crores.

This has the effect of accentuating the inequalities in the resources of States and consequently the inter-regional imbalances in the rates of growth. Such have been the invariable effects of the devolution of resources to the states in terms of the states' shares in the transfers of tax resources under the Finance Commission system, but the recommendations of the seventh Finance Commission have made the position still more glaring because of the large size of the devolution of resources largely in terms of tax shares. The reason is that the allocation of resources in the form of shares in taxes is made among the States on the basis of uniform principles and they, therefore, do not take into account the gaps of unevenness in the financial resources of the different States. The States have been pressing for larger transfers of resources in terms of shares

in divisible taxes because such transfers are unconditional and are compatible with the financial autonomy of the state. But they have the potential of aggravating the financial inequalities among the States in a context when these are already very staggering.

Allocation of Tax Receipts

The share of the states in the divisible pool of income tax has been raised from 80 per cent to 85 per cent, with regard to the distribution of share in the divisible pool of income tax, the Finance Commission has continued the existing formula of distribution with a 90 per cent weightage on population and 10 per cent on collection. The changes made in the case of the minor sources are also not of much significance. The grant in lieu of the tax on railway passenger fares has been based on the sale of non-suburban tickets in the respective States instead of on route mileage. The net proceeds of Estate duty (excluding the share of Union territories) have been "distributed in proportion to the gross volume of the immovable property and property other than immovable property taken together located in each state and brought into assessment".[1] Any property located outside India will be taken as located in the state in which it is brought into assessment. This is a change from the sixth Finance Commission formula which distributed the proceeds from movable property according to population. The grant on account of the wealth tax on agricultural property will be equivalent to net collection in each state and not proportional to the agricultural property located and assessed in the state.

The most important element in the recommendations is regarding the division of the union excise receipts between the states and the Centre. The share of the states has been raised to 40 per cent from the level of 20 per cent and this at one stroke increased the divisible pool by nearly Rs. 6000 crores in the five year period. As regards the distribution of the divisible pool of the basic excise receipts among the states, the earlier Commission had all given large weightage to population with 20 to 25 per cent weight on some indicator of backwardness. The sixth Finance Commission awarded 75 per cent of the divisible amount to each state on population and the remaining

25 per cent on the product of the population of the state and the distance between the per capita income of the State and the highest per capita income among all the states i e., the per capita income of Punjab. The Seventh Finance Commission considered this as inadequately progressive and gave its own formula which gives an equal 25 per cent weightage to each of the four factors: population, the inverse of the per capita state domestic product: a specially calculated poverty ratio and a revenue equalisation factor. But the question arises that the per capita state domestic product is not a precise indicator of per capita income in the state when it has extensive trade and payments relations with other states.

The poverty ratios used by the Commission have been worked out by Dr. Raj Krishna, one of its members. The out-off levels chosen by him were the Dandekar-Rath figures of Rs. 15 and Rs. 29.50 at 1960-61 prices per capita per month for rural and urban areas respectively. Specific poverty lines have been calculated for 15 States by using Pranab Bardhan's State indices of rural consumer prices in 1960-61 which were based on the study made by G.S. Chatterjee and N. Bhattacharya. For the urban areas, the three-year average of the working class consumer price index was used. The result has then been adjusted to 1970-71 prices by using the consumer price index for agricultural labour and that for the urban working class. These then have been further adjusted upward by adding the per capita monthly public expenditure by each State government on health and family planning, water supply and sanitation, education, administration of police, jails and courts, roads and social welfare. The 'poverty ratio' or the cumulative percentage of persons below these "augmented poverty lines" have found by linear interpolation in the relevant expenditure bracket. The number of persons below the line in each state was derived by applying the percentage to the 1971 population. The final poverty percentage for a state is the percentage of such persons in that State to the 15 state population of such persons.

From this it follows that a state's share in the total population of the 15 states may be smaller as compared to its poverty percentage. Thus Bihar has a poverty percentage of 13.03 and 10.35 of the total population of these 15 states. Its share in the

number of poor persons is thus substantially larger than its share in the total population. The States in which the poverty percentage was worked out to be higher than their share in the total population were Bihar, Kerala, Orissa, Madhya Pradesh, Tamil Nadu and West Bengal. For the six of the States other than the 15 covered by the exercise—Himachal Pradesh, Jammu and Kashmir, Manipur, Meghalaya, Nagaland and Sikkim—the poverty ratios have been assumed to be the same as that for Assam while the West Bengal ratio has been taken for Tripura.

This exercise has indicated some very interesting features. Some of the states generally considered relatively rich have shown high poverty percentage—these include Tamil Nadu and West Bengal; on the other hand, the share of Uttar Pradesh in total number of poor persons is less than its share in the total population. From a comparison of the 'poverty ratios' within the states, it was found that these (for rural and urban together) are as high as 64.06 for Bihar, 62.25 for Kerala, 67.50 for Orissa, 60.71 for Tamil Nadu and 62.28 for West Bengal. In some cases the differences between the rural and urban ratios are quite large. In West Bengal the percentage of people below the augmented poverty line is 70.82 in rural areas and 36.30 in urban areas. In Gujarat, Karnataka, Kerala and Tamil Nadu the two ratios are close to each other, while in Andhra Pradesh, Haryana, Punjab, Rajasthan and Uttar Pradesh it is the urban poverty ratio which is higher than the rural ratio.

Revenue Equalisation Formula

The principle behind the revenue equalisation formula adopted by the Commissions is that "States which are less favourably placed in regard to their resource potential should be specially helped in order to place them in a position where they also can take steps more readily for the betterment of the people."[2] The method adopted was that leaving out the states of Manipur, Meghalaya, Nagaland, Sikkim, and Tripura, the average of the per capita tax and non-tax revenues of each state for 1975-76 and 1976-77 has been regressed on the average per capita income for 1975-76. The per capita revenue potential of each state has then been derived from the distance

between the result of this and the highest estimated per capita revenue among all states i.e., of Punjab multiplied by the population of the State. As 1977-78 and 1978-79 have not been taken into account, no state has been rewarded for failure to increase resources recently, nor penalised for having raised larger revenues. But a weightage of only 25 per cent has been given to this factor in the distribution of the divisible receipts of basic excise among the states and this factor will not be able to achieve equalisation in the resources of the different states in a scheme in which there is a built-in tendency to increase inter-state disparities. Secondly, the impact of this factor of equalisation formula has not been significant because the resources involved amount only to Rs. 500 crores per year.

Additional Excise Duties

The seventh Finance Commission set two principles—one for sugar on the basis of the average despatches to the states during the recent past and the other for tobacco and taxtiles on the basis of the product of the population and per capita state domestic product. The assumption in the case of sugar is that consumption in a state is proportional to the supplies received and in the case of the other group that consumption is proportional to the state's domestic product.

The first assumption, however, is vitiated when there are movements across the state and the second does not take into account the pattern of income distribution. What appears to be most significant is that in spite of the over-riding desire to secure more equality, the seventh Finance Commission formula has allotted relatively more to states like Maharashtra and Punjab and less to states like Bihar or Uttar Pradesh as compared with the sixth Finance Commission allocation. Thus the formulae used by the seventh Commission do not constitute better determinants of state consumption than those used earlier. If the ultimate objective of the distribution of tax shares is to reduce disparities, the problem has been accentuated by the inequality resulting from the allocation of receipts from additional excises.

A comparison with the Sixth Finance Commission formula shows that for most of the states, the percentage shares have

not changed much. The benefits and losses from the new 'consumption criteria' are concentrated among a few states only. Table 10.3 shows comparative position under the awards of the two Commissions.

TABLE 10.3

	Seventh Commission			(Percentage) Sixth Commission
(1) *States*	(2) *Sugar*	(3) *Textiles and Tobacco*	(4) *Weighted Average*	(5)
1. Andhra Pradesh	5.245	8.018	7.46	8.39
2. Assam	2.408	2.297	2.32	2.47
3. Bihar	5.933	7.219	6.96	9.36
4. Gujarat	8.742	6 013	6.56	5.91
5. Haryana	2.656	2.789	2.76	1.94
6. Himachal Pradesh	0.860	0.734	0.76	0.59
7. Jammu & Kashmir	0.831	0.744	0.76	0.73
8. Karnataka	4.901	6.081	5.85	5.62
9. Kerala	3.783	4.021	3.97	3 58
10. Madhya Pradesh	6.019	6.419	6.34	6.98
11. Maharashtra	17.082	13.506	14.20	11.65
12. Manipur	0.143	0.185	0.18	0.17
13. Meghalaya	0.029	0.171	0.14	0.17
14. Nagaland	0.115	0.081	0.09	0.08
15. Orissa	2.178	3.456	3.20	3.59
16. Punjab	6.220	4.268	4.66	2.68
17. Rajasthan	4.729	4.365	4.44	4.17
18. Sikkim	0.057	0.034	0.04	—
19. Tamil Nadu	6.449	7.707	7.46	7 27
20. Tripura	0.172	0.256	0.24	0.25
21. Uttar Pradesh	13.184	12.544	12.67	16.10
22. West Bengal	8.254	9.091	8.92	8.30
Total	100.00	100.00	100.00	100.00

Note: (For making the comparison meaningful, the two schedules given by the Seventh Finance Commission have been combined with a single schedule of weighted averages assuming that the receipts from the duties in tobacco and textiles will continue to be four times the receipts from sugar) quoted from B. Datta, "Our Crumbling Federal Finance Sytem," *Economic and Political Weekly*, January 13, 1979.

A Critical Assessment

The recommendations of the seventh Finance Commission have the effect of increasing the inequalities among the states as compared to the sixth Finance Commission's recommendations for a number of reasons. Though the recommendations of the seventh Commission have increased substantially the non-Plan revenue resources of the states, the intention of securing progressiveness according to needs on the part of the Commission has not succeeded in evolving a pattern of resource allocation which could contribute to a greater balance in inter-regional development. Instead the disparities in the resources available to the states have been further magnified. The per capita transfers under the sixth Commission awards were written a smaller range of variation and were higher for states like Orissa, Bihar or Uttar Pradesh than for Maharashtra, Punjab or Haryana. The reason for the seventh Finance Commission recommendations resulting in greater inequalities among states is the much greater dependence on tax shares than on grants in resource allocation. In spite of a more equitable formula for the allocation of resources from Central excises, the recommendations have resulted in very large revenue surpluses in the non-Plan budgets of the richer states like Maharashtra, which they would use for financing development plans of a much larger size leading to increasing the disparities in inter-regional levels of economic development. For example, the surplus of Maharashtra is estimated at Rs. 3005 crores while Bihar will have a surplus of only Rs. 1092 crores and Uttar Pradesh of Rs. 1944 crores, while Orissa will have a deficit of Rs. 137 crores which would be made up by a grant of this amount recommended by the Commission.

A larger allocation of resources through grants designed on a progressive basis in relation to the poverty ratios of different states would have been a more rational and equitable method of resource allocation among states to achieve a greater measure of equalisation. The sixth Finance Commission award had given 70.12 per cent of the total transfers through tax-sharing and 29.88 per cent through grants while the seventh Commission has given 92.3 per cent through tax devolution and only 7.7 per cent through grants. The grants under the sixth Finance

Commission recommendations amounted to Rs. 2510 crores for 14 States and these were in addition to the special upgradation grants for improving administration and social services amounting to Rs. 838 crores. The seventh Finance Commission's grants to fill in the gaps in the non-plan resources for eight states come to Rs. 1173 crores and the upgradation grants are also much less at Rs. 437 crores. The eight states getting the statutory grants are Orissa and the seven hill states. These facts are, therefore, enough to show that achievement of equalisation in the resources of the states and their levels of development was not at all the guiding consideration in the recommendations of the seventh Finance Commission.

It is true that the states have shown a much greater interest in allocation of larger resources through tax sharing and there are some way justifiable reasons for larger allocation of resources through the device of tax shares. They stimulate the interest of the states in developing the tax basis of the economy and they share in the buoyancy of resources. But the allocation of resources through tax shares on the basis of uniform principles among states is bound to accentuate the inequalities among states. A better method to achieve equalisation would have been to reduce the importance of tax shares in resource allocation among states and to increase the importance of grants which could act as equalisers. The achievement of inter-regional balance in development would involve the allocation of per capita much larger resources to the poorer states as compared to the richer ones and not an equal per capita transfer as some have wrongly argued.

Raj Krishna Formula

It is necessary here to analyse the formula devised by Dr. Raj Krishna, in his minute of dissent to show if this formula was better-designed to achieve equalisation in the resources of the states. Though Dr. Raj Krishna was the author of the poverty percentage criterion used by the Commission in the allocation of receipts from basic excises, the additive 25 per cent weightage on the four factors referred to before was criticised by him in his dissenting note on the ground that it was not sufficiently progressive. In this minute of dissent he was also

against giving any weightage to collection or contribution and, therefore, recommended a common formula for the allocation of both income tax and the basic Central excises. He recommended the distribution of the divisible pool of these taxes on the basic of what he called the "income adjusted poverty population" of each state. This was derived by multiplying the population of the state by the poverty ratio (i.e., by taking the total number of persons below the augmented poverty line) and then dividing it by the per capita income. The revenue distance, the fourth variable used by the majority of the seventh Commission, was considered important by him but it was brought in only when determining the amounts of grants.

The Raj Krishna formula is that if the population of a state is n, the number of persons below the poverty line is p and the state domestic product is y, then the 'poverty ratio' $r=p/n$ and the income-adjusted poverty population,

IAPP$=\dfrac{nr}{y/n}$ which can be put as $\dfrac{n^2r}{y}$ or $\dfrac{np}{y}$. The 'poverty percentage' of any state is its own IAPP as a percentage of the total IAPP or all states. Thus, it will mean that in terms of this formula the share of a state will vary directly with either population or poverty ratio and inversely with its per capita income. It also follows that if two states have the same domestic product and the same number of poor persons, their share would differ according to their total populations. If, however, two states have the same total state domestic product and the same poverty ratio, their shares will differ according to the squares of their respective populations.

The majority report gave a large weightage to population in the transfer of resources, but the Raj Krishna formula has also assigned it a large importance in the scheme of resource allocation, though this formula is more equitable than the formula evolved by the majority report. Under the Raj Krishna formula the proportion of resources transferred to the states through tax shares would have been 91 per cent as compared to 92.3 per cent under the majority formula and so the former would have made only a marginal change in the scheme of resource allocation. As Dr. Bhabatosh Datta has pointed out, "the majority scheme ratains a substantial weightage on population, directly and indirectly, despite the complex formula.

Population remains an important element in the Raj Krishna formula also almost as important as the sixth Commission scheme."[3] The reason is that the poverty ratio and total population are variables not independent of the total population of a state.

The differences between the final surpluses of the different states and of the per capita transfers are smaller under the Raj Krishna formula than under the majority scheme. Leaving out the hill states, the minimum surplus per capita is Rs. 15 for Orissa under the majority allocation and the maximum Rs. 676 for Haryana (Punjab Rs. 597, and Maharashtra Rs. 596 near the top of the scale and Rajasthan 85 and Assam 74 near the bottom), under the Raj Krishna formula every state gets a minimum per capita surplus of Rs. 100 and the maximum is Rs. 577 for Haryana. The ratio between the lowest and highest per capita surpluses is 1 to 45.1 in the majority scheme while it is 1 to 5.8 in the Raj Krishna plan and so it is more equitable and progressive than the majority scheme of devolution which was accepted by the Union government.

Debt Relief

An important feature of the gain derived by the states from the award of the seventh Finance Commission is from the debt relief measures. At the end of 1978-79, the total debts of the State governments were estimated to be of the order of the 18,785 crores in which the liabilities to the Central Government stood at Rs. 13,463 crores and the market loans Rs. 2572 crores. The remaining amount comprised negotiated loans, compensation boards, provident funds and other unfounded debt. The Commission estimated that Rs. 943 crores out of the total debts to the Centre represented unproductive loans in the sense that they were not expected to yield any financial returns. These included the loans used for public works, roads and bridges and also for education and social welfare. The Commission recommended for this no-return debt to be written off. The states have, however, benefited unequally from this relief because the loans of this category constituted varying percentages of their total debts to the Centre. These percentages were naturally high for the new states. Among the other states, the

percentages vary from zero in the case of a number of major states to 25 for Kerala and 45 from Assam.[4]

The remaining amount of debt except the small savings loans was consolidated into one loan in term of its recommendations and then divided into two parts. One part, classified as semi-preductive i.e., not yielding adequate returns, is to be repaid in 30 equal instalments from 1979-80 and the other part, designated as 'productive', is to be repaid in 15 annual instalments. The rates of interest on those consolidated debts would be 4.75 and 5.00 per cent respectively.

All these together have meant a substantial relief to the State governments both in interest payment and in annual repayments. Leaving out the hill states, one finds that the five year relief on this account varies from Rs. 38 crores for Haryana to Rs. 368 crores for Uttar Pradesh, the total for all states amounting to Rs. 2,156 crores.

The Commission also recommended that the states' share in the small savings collections outstanding at the end of 1978-79 should be consolidated and then converted into loans in perpetuity. This means that the liability of the states to pay interest will continue, but the liability to repay the depositors would be borne entirely by the Centre.

The Central Government, however, has not accepted this recommendation, though there is considerable strength in the argument of the Commission that the small savings loans are not given to the states for the specific purposes and are, therefore, not classifiable and also that the State governments play a vital role in mobilising the collections of small savings. The Central Government, however, has agreed to grant five-year moratorium on the repayment of these small savings loans, thus leaving the Commission's operative estimates undisturbed.

Natural Calamities

Another important feature which all the states have welcomed is with regard to the financing of the expenditure on account of natural calamities. The sixth Commission recommendations had provided that the amounts granted by the Centre in excess of the amount included in the non-plan revenue expenditure estimates should be regarded as advance plan assistance

to be set off against future plan disbursements. This was bad in principle because it did not differentiate correctly between the consumption and investment elements in the so called relief expenditure. So to the extent that such expenditure is protective, preventive or developmental, there is every reason to include it in the plan outlay. But a large part of the expenditure immediately following a calamity is not of this nature. If such expenditure is set off against future plan outlay, the whole plan structure is distorted. This is particularly true in case of a large calamity.

The seventh Finance Commission has very rightly distinguished between droughts which do not destroy productive assets and the other group comprising floods, cyclones and earthquakes which require large outlays on assets reconstruction. The expenditure estimates for the states include a normal provision for all types of natural calamities. The procedure adopted for determining these amounts was the same as that followed earlier—taking the average of actual expenditure over a recent series of years—and it gave figures which were nearly double the amount provided by the sixth Commission. In the case of excess requirements for drought relief the affected State government is to contribute not more than 5 per cent from its plan. This will be taken as an addition to the plan outlay and covered by advance assistance from the Centre. If the expenditure goes beyond this the extra requirement would be fully covered by the Centre—half as grants and half as loans. The Commission expressed the hope that "the loan burden which a State would take on in such circumstances would act as a factor to discourage extravagance."[5]

In the case of excess expenditure on relief, repairs and restoration of public works following other types of natural calamities, the Commission has recommended non-plan grants to cover 75 per cent of the requirements. Here also the Commission hoped that the 25 per cent burden on the state would be a check on wasteful expenditure. The Centre has been asked to go beyond these limits when there is a calamity of rare severity. This would give substantial relief to states which are prone to natural calamities. But the debatable point is why should the expenditure on account of relief for drought be regarded as plan expenditure unless it includes a large element

of protective or preventive outlay.

Conclusion

The analysis of the fiscal impact of the recommendations of the seventh Finance Commission on the finance of the State governments shows that though substantially large transfer of resources would result to all the states, the element of progressiveness in resource transfers seems to have been weakned rather than strengthened. This would result in further accentuating differences in fiscal capacities of the different states and widen the gap in their levels of development.

Therefore, the logic of achieving a balanced inter-regional development leads to the assignment of a crucial role to the process of planning and development through the mechanism of the five year plans. The development plans of the poorer states would have to be of much large size to give a fillip to their rate of development so as to reduce disparities in inter-regional levels of development. This would mean that the task left incomplete by the seventh Finance Commission would have to be taken up by the Planning Commission. As the development plans of the poorer states would have to be of larger size, they would require much larger financial assistance from the Central government to finance them. This would, therefore, involve the designing of a new formula of resource transfers from the Centre to finance the State Plans which should be more progressive and equitable than the Gadgil formula.

References

1. *Seventh Finance Commission Report*, p. 121.
2. *Report of the Seventh Finance Commission*, p. 87.
3. Dutta, B. "Out Crumbling Federal Finance System", *Economic and Political Weekly*, January. 13, 1979.
4. *Report of the Seventh Finance Commission*, p. 113.
5. *ibid*, p. 53.

11

RESTRUCTURING THE SYSTEM OF PUBLIC FINANCE IN INDIA

The existing structure of Indian public finance has been in operation for more than a quarter of a century and its working in this period has been affected by a number of developments. It has revealed a number of problems not envisaged originally as a result of its operation. The most significant development has been the process of planned economic development initiated with the launching of the First Five-Year Plan in April 1951. This has been followed by successive five year plans with the Sixth Plan intended to begin from 1978-79. Each successive plan has involved practically a doubling of the development outlays in the public sector as a result of which increasingly larger resources have been needed to finance the plan outlays. This has strained the Indian fiscal system to the utmost and has put it to a supreme test to judge its potential as a flexible and effective instrument of economic development.

The increase in the plan outlays has, however, led to an increase in the non-plan outlays also for the maintenance of the assets so created and the administrative expenditure had to be increased all round in response to the demands for the implementation of the five year plans. As a result an increasing imbalance has tended to develop between the own resources of the states and their expenditures and the gap has tended to widen with the successive five year plans. These gaps have been filled up by the devolution of resources from the Union government in terms of statutory devolution as share in divisible and assigned taxes, Central grants and loans. But though as a result of these devolutions of resources, a large measure of elasticity has been imparted to the revenue resources of the states, the states' dependence on the Central resources has increased. This tendency to growing fiscal centralisation has

created a feeling among the states that their progressive fiscal autonomy was eroded and that they did not have any initiative and scope for freedom of action in any sphere of governmental activity.

Problems of State Finances

But the growing fiscal centralisation and consequent erosion of financial autonomy of the states is only one aspect of the problem of federal finance in India and not the only aspect. An important aspect of the problem of federal finance is concerned with fiscal management by the states themselves. In this regard there are a number of problems of the states' finances. The states have not exploited the resource potentials in the rural sector of the economy. The most important fiscal instrument to tap those potentials is the system of land taxation. But land taxation, as it has existed in India, has been essentially a tax *en rem* with highly regressive incidence. It has not been responsive to the growth of farm output, farm incomes and farm prices with the result that its importance in the tax structure of the states has tended to decline. This is indicated by the fact that in 1977-78 the land revenue receipts of the states amounted to only 4.6 per cent of the states' own tax revenues, while sales tax constituted 56.8 per cent of the states' own tax revenues. Besides there have been mounting accumulations of arrears of taxes, large scale evasion and avoidance of taxes especially the sales taxes and accumulating arrears of loans advanced to different parties. The attention of the states was drawn to these problems by the successive Finance Commissions and the sixth Finance Commission in making a reassessment of the revenue forecasts of the states had assumed that the states would make utmost efforts to reduce these arrears to the minimum. But these assumptions have not been realised and the arrears of tax and loan collections have increased. The fifth Finance Commission had estimated the amount of arrears to be Rs. 186 crores by the end of March 1969. Arrear on account of land revenue and sales tax which accounted for nine-tenths of the total arrears increased from Rs. 106 crores in 1963-64 to Rs. 146 crores in 1967-68. Further in the case of land revenue, the arrears were consistently more than 30 per cent of current dues

in the case of a few states. In the case of sales tax, arrears formed more than one fifth of the current dues in a few States.

Thus the increasing dependence of the states on the Central resources is to be partly explained in terms of their failure to tap their tax potentials in the rural sector and to improve their tax administration to make effective collections of revenues and loans. From this point of view, therefore, a part of the solution of the problem of federal finance in India lies in the utilisation of the tax potentials by the states and the streamlining of their fiscal administration.

A number of proposals, beginning with the recommendations of the Taxation Enquiry Commission, 1953-54, and ending with the Raj Committee Report, have been made for the reconstruction of the system of land taxation in India, but none of these proposals has been implemented by the states. The Planning Commission in the plan documents has also been emphasising the importance of raising greater resources by the states through the revision of land revenue rates. But these rates have not been revised in most cases except in some states where surcharges have been imposed and the rates revised on plantations. The failure of the states to transform the system of land taxation into an effective instrument of resources mobilisation lies essentially in the political factor and the party in power in the states has been afraid of alienating the powerful rural sections for fear of losing the elections.

Another problem of states finances that has emerged in course of the implementation of the Five-Year Plans is the losses incurred by the semi-commercial and commercial enterprises built up in the states' sector. These enterprises such as the State Electricity Board, the Road Transport undertakings and the industrial enterprises have not been able to meet their maintenance expenditures and their mounting expenditures for their maintenance have added to the non-plan expenditures in budgets of the states.

Concept of Fiscal Capacity and Need

In the assessment of the non-plan gaps in resources of the states the successive Finance Commissions recommended grants-in-aid under Article 275 of the Constitution to bridge

these gaps and in doing so they tried to measure their fiscal capacity and need. Thus the concept of fiscal capacity and need has been of crucial importance in the scheme of allocation of resources from the Union government to the states. The Finance Commissions adopted the concept of fiscal capacity of states in terms of their proposals to raise resources based upon the states' forecasts of their revenues and the fiscal needs were also measured in terms of the states' forecasts assessed on the basis of certain norms of growth. Fiscal need so measured was, therefore, a narrow concept in so far as it did not take into account the needs for resources to finance the plans. This task was left to the Planning Commission. It was the non-plan needs that have been assessed by the Finance Commissions.

In the assessment of non-plan needs, a new concept was introduced by the third Finance Commission in terms of the committed expenditure arising out of the implementation of the Five-Year Plans. But the subsequent Finance Commissions took the view that unless the assets created as a result of the implementation of plans generated sufficient resources for their maintenance, the committed expenditure would eat up the essential resources and adversely affect the financing of development expenditure. In view of this, the sixth Finance Commission undertook an elaborate exercise to evolve norms for maintenance of capital assets and plan schemes.

One important question engaging the attention of the Finance Commissions in the assessment of non-plan needs of the states was whether provision for amortisation should be included in the non-plan needs. The second and third Finance Commissions were in favour of making provision for amortisation of debt where such provision was to come out of grants under Article 275. The fourth Finance Commission allowed full provision as indicated by the states in their forecasts, the amount allowed by the fifth Commission was limited only to the provision in respect of debt (existing as well as fresh) not covered by revenue yielding investments and loans. The sixth Finance Commission, however, did not consider it necessary to allow for any element of amortisation of debt in the revenue accounts of the state governments in view of the proposals recommended by it for affording adequate relief to the states during the Fifth Plan period.

Fiscal needs of states as assessed by the Finance Commissions also included the cost of relief expenditure on account of natural calamities. The concept of fiscal needs as assessed by the Finance Commission has, therefore, tended to be widened and the sixth Finance Commission made it much broader by including a number of new items. But a careful examination of the concept of fiscal needs adopted by the Finance Commissions reveals two basic deficiencies. In the first place, such assessment has been limited to the non-plan needs only though in all fairness it must be pointed out that the concept of non-plan needs was made wider by the successive Finance Commissions. Thus, the Finance Commissions did not take into account the plan needs of the states. This was the task reserved exclusively for the Planning Commission. This approach to the assessment of the fiscal needs of the states is unsatisfactory. An integrated view of both the plan and non-plan needs of the states should be made to evolve any satisfactory schemes of resource allocation in the context of the working of system of federal finance and much of the dissatisfaction of the States with the present arrangement of resource allocation arises out of this dichotomy.

Secondly, in the assessment of the non plan needs of the states, no consideration was given to the necessity for equalisation of the standards of social and administrative services of the various states.

Only the first, the third, and the sixth Finance Commission considered this aspect of the question. The first Commission recommended grants-in-aid for improvement of primary education in some states, and the third for improvement of communications. But their approach in this regard was largely of an *ad hoc* nature. The sixth Finance Commission recommended grants-in-aid to some states for upgradation of some of their essential administrative and social services. But an analysis of its impact on the states' finances (in the earlier chapter) shows that there exists vast disparities in this regard even now. The analysis of the recommendations of the seventh Commission in the previous chapter has revealed that it was not guided by the consideration of equalisation.

The achievement of equalisation has two aspects in the Indian economy. One is the equalisation of the standards of administrative services in the states, and the second is the

achievement of regional balance in development. The administrative services are an instrument to implement the development plans, and so long as the administrative services have lower standards in some states, they will continue to have lower growth rates since their development plans cannot be effectively implemented in them. This is borne out by the lower performance and large shortfalls in plan outlays in the relatively backward states.

Equalisation of the standards of administrative services can be achieved only over the long period, but a planned programme should be drawn up suitably phased to achieve it. A beginning was made by the sixth Finance Commission in this direction and the process should be continued so long as equalisation is not achieved in basic administrative and social services. But the achievement of regional balance is an objective of development planning for which the technique of planning will have to be modified. The area development programme, initiated under the Five Year Plans and expected to be pursued with greater vigour in the Sixth Plan, based upon the utilisation of local resources, talent and manpower can be an important instrument in this direction. At the same time, the size of the state plans should be so designed and the plan resources so allocated so as to accelerate the rates of growth of the comparatively backward states to enable them to utilise their resource potentials more fully and thus to even out the disparities in the levels of development. This, however, can be achieved only in terms of a process of long term development planning.

The fiscal capacity of a state can be indicated in terms of a number of criteria such as per capita income, the distribution of income, the degree of urbanisation and the industrialisation of a state. But it is difficult to quantify all these criteria of fiscal capacity. The fifth Finance Commission adopted the criterion of revenue income ratio, i.e., the ratio between the per capita revenue and per capita income of a state for indicating the effect of a state in raising resources and it was revealed that some of the states have not adequate tax efforts to mobilise their revenue potentials fully even when their per capita incomes were higher. Thus there has been no correspondence between fiscal capacity and actual utilisation of fiscal capacity.

The fiscal capacity of a backward state in a federal system is

less than that of a developed state with the result that resources raised by the backward state are less in per capita as compared to those by a developed state. Therefore, in a scheme of allocation of financial assistance from the Centre to the states the relative fiscal capacity of states serves as a basis for measuring the gaps which have to be filled up to bring them to equal levels of performance. But if a state does not utilise its resource potentials fully, it must be penalised and a state using its potentials fully should be rewarded in any scheme of federal allocation.

The sixth Finance Commission devoted some thought to the question of further refinement of the methodology followed by the fifth Finance Commission and evolving certain criteria for determining the relative tax performance of the states. But it gave up the effort on the practical consideration that application of a formula based on relative tax effort, however designed, would place at a disadvantage some of the states faced with big gaps on non-plan revenue accounts. The Commission, therefore, felt that to leave such gaps uncovered on the ground of their poor tax performance, however defensible on theoretical considerations, would jeopardise maintenance of essential administrative and social services for want of adequate resources. States, both advanced and backward, which have done better than the average at resource mobilisation might feel aggrieved that their efforts have not received recognition. Therefore, it was of opinion that if in the determination of the principle of Central assistance for the Plan, some weightage is given for the relative efforts of the states for mobilisation of resources, the grievance of such states would be substantially met.

Tax Effort of States

An important aspect of federal finance is concerned with the effort made by the states to utilise their resource potentials. In a developing economy as the national income increase, the potential of the economy to raise resources also increases. The utilisation of the resource potentials so generated becomes necessary to increase the rate of saving and investment and so to accelerate the rate of growth of the economy.

In a federal system, the allocation of resource from the

Centre to the states must take place in a manner so as to ensure that the states maximise their efforts to raise resources and that the incentive for raising resources should not be adversely affected. The system of resource allocation should also ensure fiscal efficiency by states which implies that efficiency should be rewarded and lack of efficiency penalised. Though these are second principles of federal finance, it is however, difficult to put them into practice because of practical difficulties.

The concept of fiscal capacity of a state which is an important issue in federal finance assumes that a state makes maximum efforts to raise resources through the utilisation of its potentials. The question, however, arises as to the method to measure the tax efforts. To measure tax efforts, the fifth Finance Commission related per capita tax revenues of each state to state per capita income. It found that the tax effort as measured by the ratio of per capita state's own revenues to the state's per capita income showed wide divergences from state to state as revealed in Table 11.1.

TABLE 11.1

States	*State income for 1962-63 to 1964-65 (Average)*		*Tax Revenues in 1967-68*		*Percentage of Tax Revenues to State Incomes*
	Total amount (Rs. crores)	*Per Capita (Rs.)*	*Total amount (Rs. crores)*	*Per Capita (Rs.)*	
1	2	3	4	5	6
Punjab	595	492	50.20	37.46	8.44
Maharashtra	2019	478	168.28	36.50	8.34
West Bengal	1742	465	108.11	26.30	6.21
Gujarat	1025	462	71.90	29.59	7.01
Haryana	367	445	26.34	28.95	7.18
Tamil Nadu	1408	400	109.54	29.37	7.78
Assam	503	393	26.31	18.66	5.23
Andhra Pradesh	1460	386	79.48	19.67	5.44
Mysore	936	373	63.10	23.28	6.74
Kerala	616	341	53.79	27.44	8.73
Madhya Pradesh	1126	325	63.54	16.94	5.64

1	2	3	4	5	6
Rajasthan	683	314	46.60	19.50	6.82
Uttar Pradesh	2398	306	123.09	14.60	5.13
Orissa	568	306	24.25	12.12	4.27
Jammu and Kashmir	111	302	7.58	19.44	6.83
Bihar	1308	265	64.29	12.06	4.91
Nagaland	N.A.	N.A.	0.23	5.75	N.A.
Total	16865	369	1086.63	21.92	6.44

In the case of states having per capita income below the all-State average, the ratio varied between 8.73 per cent for Kerala to 4.27 per cent for Orissa. For states with per capita income above all state average the range was between 8.44 per cent for Punjab and 5.23 per cent for Assam. Thus higher per

TABLE 11.2

States	*Taxes on Land*	*Taxes on Land as percentage of States Agricultural incomes*	*State Excise*	*Taxes on Transport*	*General Sales Tax*	*Total Tax Revenues*
Punjab	0.28	0.52	2.30	0.90	1.90	7.61
Maharashtra	0.40	1.20	0.19	1.21	2.95	7.63
West Bengal	0.51	1.48	0.69	0.74	1.43	5.66
Gujarat	0.59	1.43	0.06	1.08	2.61	6.23
Haryana	0.35	0.63	1.54	0.95	1.38	6 51
Tamil Nadu	0.46	1.18	0.05	1.47	2.75	7.34
Assam	1.16	2.21	0.53	0.77	1.33	4.35
Andhra Pradesh	0.51	0.95	1.03	0.77	1.78	5.10
Mysore	0.91	1.89	0.70	1.14	2.69	6.24
Kerala	0.77	1.76	1.39	1.41	3.05	8.05
Madhya Pradesh	0.60	1.16	0.97	0.68	1 57	5 21
Rajasthan	1.35	2.49	1.04	0.77	2.21	6.21
Uttar Pradesh	0.99	1.78	0.78	0.56	1.34	4.77
Orissa	0.27	0.52	0.47	0.51	1.21	3.96
Jammu & Kashmir	0.49	1.00	1.48	3.07	0.85	6.54
Bihar	0.24	0.52	0.76	0.40	1.40	4.55
Nagaland	–	–	–	–	–	–
All States	0.62	1.34	0.71	0.89	1.95	5.36

capita income did not mean higher ratio of tax revenues to per—capita income. This meant that the states falling in this category did not utilise their tax potentials fully. The Commission also referred to the existence of substantial differences between tax efforts of states which are similarly situated as regards their per capita income and economic structure, for instance among states with higher per capita income, the tax income ratio was more than 8 per cent in Maharshtra and Punjab while the ratio in West Bengal with a similar industrial base was only 6.21 per cent. Thus many states could raise additional resources by studying the tax system and rates adopted by the more highly taxed states in their own income groups.

With regard to individual taxes, the Commission found wide disparities in tax efforts as measured in terms of tax-income ratio as indicated in Table 11.2 (page 251).

The Fifth Finance Commission had examined the question ten years back. It is, therefore, necessary to enquire whether the picture has changed during the period.

Table 11.3 showing the ratio between per capita tax revenue and per capita income of states throw a light on the question:

TABLE 11.3

States	*(In rupees) Per capita own tax revenue (1977-78) estimated in terms of the population of States in 1971*	*(In rupees) Per capita income 1971*	*Percentage of per capita tax revenue to per capita income*
1		3	4
Andhra Pradesh	84.5	545	15.5
Assam	42.6	545	7 8
Bihar	41.1	402	12.2
Gujarat	117.3	657	17.8
Haryana	147.7	788	18.6
Himachal Pradesh	57.6	563	10.2
Jammu and Kashmir	45.1	513	8.8

1	2	3	4
Karnataka	100.5	532	19.0
Kerala	96.4	526	18.3
Madhya Pradesh	66.1	554	11.7
Maharashtra	154.0	778	19.8
Manipur	29.5	476	6.2
Meghalaya	23.9	N.A.	—
Nagaland	41.2	N.A.	—
Orissa	45.6	325	14.0
Punjab	167.4	945	17.7
Rajasthan	63.0	488	13.0
Sikkim	5.0	N.A.	—
Tamil Nadu	89.4	644	14.0
Tripura	14.6	499	3.2
Uttar Pradesh	49.0	504	9.8
West Bengal	83.0	524	15.8

It is found as a result of the analysis of the above figures that Assam with the same per capita income as Andhra Pradesh has a tax-income ratio much less than that of Andhra Pradesh. Therefore, it follows that the state can increase its tax revenues by greater efforts to exploit its tax potentials by restructuring its tax system and raising the rates of taxes. Himachal Pradesh, Jammu and Kashmir and Manipur have higher per capita income than that of Bihar, but the tax-income ratio is much lower in these states as compared to that of Bihar, Maharashtra, Punjab and West Bengal with per capita incomes higher than the all-India average and with basically similar economic structures have different tax-income ratios, while Karnataka with practically equal per capita income with that of West Bengal has a much higher tax-income ratio. Orissa with the lowest per capita income has a higher tax-income ratio than that of Rajasthan, Uttar Pradesh and Bihar and equal to that of Tamil Nadu.

Thus though there has been a rise in the tax-income ratios in all the states as compared to those estimated by the fifth Finance Commission, the picture that emerges is in no way different from that presented by this Finance Commission. Not only there exists, wide differences in utilisation of resources, but there is a scope in many states such as Assam, Uttar Pradesh, Himachal Pradesh, Jammu and Kashmir, Manipur, Rajasthan,

Madhya Pradesh, Tamil Nadu, Tripura and West Bengal for raising additional tax resources by utilisation of resource potentials so that their tax-income ratios could become comparable to those of similarly situated states.

A similar picture emerges with regard to individual taxes also such as land revenue, excises, and sales taxation. In case of land revenue, the reasons for the low tax income ratio have been already referred to. Besides in many of the states, there is a loss either partially or wholly in revenue from this source as a result of various concessions and exemptions given by them. The fifth Finance Commission had estimated that the exemptions which varied from state to state were expected to cost the states Rs. 78 crores during the Fourth Plan Period.

There is hardly any economic justifications for exemptions. The argument that the smaller farmers are living below the subsistence level and that they have no taxable surplus is not sound and convincing in a developing economy. The incidence of land revenue has been considerably reduced as a result of inflationary price rise and rise in agricultural incomes and productivity due to the introduction of new farm technology. Besides in a country with low national income, trying simultaneously to develop its economy and to provide for better social welfare, it is not possible to avoid taxation of persons with low incomes. A part of the land revenue is justified on the ground that the state has to incur considerable expenditure for maintaining up-to-date records of land rights. There is enough evidence to show that the cultivator greatly values this service and regards land revenue receipts as evidence in his possession of his title to the land. The Report of the Uttar Pradesh Taxation Enquiry Committee has pointed out that none of the farmers giving evidence before it had demanded the abolition of land revenue.

Therefore, the solution of the problems of state finances in India is closely related to the transformation of this system of land taxation into an effective fiscal instrument. For this a simple method of levying surcharges at progressive rates and relating them to the rise in agricultural incomes, productivity and prices will have to be devised. But the states must have the political will to enforce the system effectively.

In respect of sales tax, one problem of raising additional

resources by some states has been that they could not raise these rates because of the low rates prevailing in neighbouring states. There is evidence of evasion of sales tax as revealed by the Uttar Pradesh and Kerala Taxation Enquiry Committees. Therefore, a co-ordination in tax policies of states and improvement in their administrative efficiency are of vital importance in the utilisation of resource potentials of sales taxation.

But in this regard two kinds of tax reforms have been further suggested. One is the replacement of the present system of sales taxation by a value added tax administered by the Union Government and the net proceeds distributed among the state on the basis of some objective and acceptable criteria. The second is the replacement of the present system of sales taxation by excises and their net proceeds to be distributed among the states as suggested by the Jha Committee on Indirect Taxation. But it does not appear that the states will agree to those proposals of fiscal reform. In the circumstances, co-ordination in tax policies and improvement of fiscal efficiency are the only alternatives which can be vigorously pursued to raise additional resources through sales taxation.

An important element of instability has been imported to the basis of states' finances as a result of the recent introduction of the policy of prohibition which would involve a total loss of revenues amounting to Rs. 547.53 crores as estimated in 1977-78 budget estimates of the states as a whole which worked out as 12.4 per cent of their own tax revenues. The introduction of the policy of prohibition raises a number of issues which are both fiscal and non-fiscal. It is argued that prohibition is an important aspect of economic development intended to raise the living standards of the bulk of the population. But the policy will succeed in this objective only if it be effectively enforced which will involve additional expenditure on enforcement and administration. If, however, the policy is not effectively enforced, it will involve huge loss of precious resources which could be used for accelerating the rate of economic development and at the same time will eat up additional resources. Thus the policy will have very fundamental repercussions on the future growth of the economy. The question has to be resolved in terms of national priorities and a scientific and rational approach to the question is necessary,

though it appears difficult in the present situation because the question is bound up with enormous political overtones and moral sentiments.

The States' Indebtedness

An important problem of federal finance in India at present is the indebtedness of the states to the Centre. The states' indebtedness has been steadily increasing as a result of increase in their plan and non-plan expenditures and the major proportion of the loans borrowed by the states is from the Centre. The states have, therefore, to make growing repayments of debt liabilities to the Centre as well as interest payments as a result of which the net receipts of loans from the Centre have tended to be considerably reduced. The problems of States' indebtedness were expansively examined by the sixth Finance Commission and it agreed that they have been allowed to become far too complex over the long period.

The loans borrowed by the states from the Centre have been of various kinds: (1) Plan loans intended, (*a*) to finance state plan schemes, (*b*) to finance Central Plan Schemes, (*c*) to finance Centrally sponsored schemes, and (2) non-plan loans: (*a*) as share of small savings collections, (*b*) to finance relief for national calamities, (*c*) others such as ways and means advances to meet temporary budgetary difficulties, and (*d*) to clear their overdrafts from the Reserve Bank of India.

It is an accepted maxim of the theory of public finance that if on the basis of loan finance, productive assets be created which generate a flow of income, such loans do not involve a burden at all. But it is difficult to examine the question of states' indebtedness to the Centre in terms of assets and liabilities. As the sixth Finance Commission put it, "it would be futile exercise to regulate debt relief with reference to the relative position of assets and liabilities of the State Government." This is because some of the assets and liabilities shown in the Finance Accounts of the States cannot be taken at their face value. Thus loans to cultivators, sick mills, refugees and repatriates figure as assets in the books of the state, but no reliable estimate can be made of the extent to which these loans would be eventually recoverable.

The sixth Finance Commission was of the opinion that though the debt liabilities of the states have increased considerably there was nothing intrinsically alarming about the growth of the public debt of the states. It maintained that the continuous increase in the indebtedness of the states to the Centre only reflects the assistance provided by the Centre to the states year after year for financing not only their plan outlays but also for meeting their non-plan needs such as those arising from relief expenditure on natural calamities.

The point of view of the states with regard to their debt liabilities to the Centre has been, however, quite different. In their memoranda presented to the sixth Finance Commission, they had argued for the classification of their debt into productive and unproductive debt and the conversion of the unproductive debt either into grants or being written off. But their contention was not accepted by the Finance Commission for various reasons: one important reason being that this would adversely affect the flow of resources from the Centre to the states because it would affect the pool of resources available with the Centre.

The problems of the states' indebtedness to the Union Government have many aspects. Not only their amount is large and they involve a large burden of amortisation payments, but their maturities, rates of interest and terms of repayment also differ. The sixth Finance Commission had estimated that the loans given by the Centre to the states and expected to be outstanding in 1973-74 would number over 12,000. The terms of these loans, such as rates of interest, period of repayment, period of grace and the like also revealed a bewildering variety as the Commission found it.

The sixth Finance Commission made a number of proposals for revision of the terms of Central loans as a result of which the repayment obligation of the States during the Fifth Plan was expected to be reduced to the extent of Rs. 1970 crores. To this event, the non-plan capital gaps of the states was reduced and they were enabled to finance a larger proportion of their plans out of their own resources. Besides, the complaint of the states that there was very little net flow of Central loan assistance to the states for implementation of the plan was partially redressed.

The approach adopted by the sixth Finance Commission to give debt relief to the states consisted in classifying the amounts outstanding under different needs, consolidating the loans of certain categories and fitting the terms of their repayment. As a result of this approach, an order and coherence was introduced in the pattern of states' indebtedness to the Centre. In the light of the basic approach and principles adopted by the sixth Commission, a number of guidelines emerged with regard to the treatment of Central loans to the states.

Firstly, loans of similar nature must carry similar terms of repayment such as period of maturity, rate of interest and period of grace. Secondly, the Central loans to the States must not turn a profit to the Union Government in that these loans should be given at the rate at which the Union Government would raise loans from the market with the same period of maturity. Thirdly, the loans received from the international financial institutions such as the World Bank and the International Development Association should be allocated to the States on the same terms and conditions governing them as made to the Union Government.

But in spite of the debt relief to the states recommended by the sixth Finance Commission for the period of the Fifth Plan and accepted by the Union Government, it is found that the interest payments still constituted a significant proportion of the tax revenues of the states in 1977-78 as indicated by Table 11.4.

TABLE 11.4

States	*Interest payment as % of total expenditure*	*Interest payment as percentage of their total own tax revenues*
1	2	3
Andhra Pradesh	6.4	15.9
Assam	11.5	46 7
Bihar	9.8	25 9
Gujarat	6.7	12.7
Haryana	7.3	14.9
H.P.	7.8	49.2

1	2	3
Jammu & Kashmir	11.4	126.9
Karnataka	6.0	13.8
Kerala	7.0	17.0
Madhya Pradesh	6.8	18.4
Maharashtra	5.6	10.3
Manipur	5.2	99.1
Meghalaya	4.2	80.0
Nagaland	4.5	134.0
Orissa	10.2	43.4
Punjab	7.8	13.0
Rajasthan	11.0	38.0
Sikkim	0.4	7.5
Tamil Nadu	7.8	15.0
Tripura	5.2	122.7
Uttar Pradesh	8.5	25.4
West Bengal	8.4	18.4
Total	7.7	19.0

The above figures reveal a very disturbing picture of the finances of some of the states. The relatively backward states like Assam, Bihar, Himachal Pradesh, Orissa, Rajasthan and U.P. are in a difficult position in which a significant proportion of their own tax revenues is used up in interest payments of which a substantial proportion goes to the Union government. This, therefore, has been making a large inroad into their tax resources which could otherwise be used for accelerating their development process. The case of Jammu and Kashmir, Manipur, Meghalaya, Nagaland and Tripura is separate because they are in receipt of large Central assistance mostly in the form of loans, but interest payments in these states have been eating up more than their own tax revenues in most cases.

The rationalisation and consolidation of the state loans to the Union government, though a step in the desired direction in terms of the recommendations of the sixth Finance Commission, cannot, however, solve the basic problems of the states' indebtedness. The solution, to a large extent, lies in an efficient management of their finances. This means that in the first place the public undertakings and irrigation works built up in the states' sector, which have involved enormous investment of resources, must generate a sufficient rate of return to pay for

their maintenance costs and to leave a surplus which could strengthen the finances of the states. The question was thoroughly examined by the sixth Finance Commission and it laid down specific norms to be followed by the State Electricity Boards and Irrigation Works as well as other undertakings.

Besides the states have advanced large volumes of loans to agriculturists and others for various purposes and it has been estimated that in their budgets of 1977-78 they made a provision of Rs. 1343.4 crores as loan and advances to third parties. In 1975-76 this amount was of the order of Rs. 1089 crores and in 1976-77 of the order of Rs. 1224.9 crores. The recovery of loans and advances in 1975-76 amounted to Rs. 420.2 crores, in 1976 77, Rs. 399.5 crores and Rs. 345.2 crores in 1977-78 (B.E.). This has led to the accumulation of large arrears of loan realisation and realisation of interest. Therefore, it is important that if the finances of the states are to improve and the burden of debt repayments is to be lightened, the states must realise their loans and interest from the third parties effectively. A vicious circle appears to have been built up in which the Central loans to the states have tended to increase. A significant proportion of these loans has been made to the third parties by the states, but they have failed to realise them effectively with the result that increasing burden has been placed on the states' finances forcing them to seek more and more Central financial assistance. This vicious circle needs to be broken through efficient financial management.

The problems of the states' indebtedness to the Centre was thoroughly gone into by the seventh Finance Commission also and it gave substantial relief to them in this regard which has been discussed in the previous chapter.

Allocation of Divisible Pool of Shared and Assigned

Taxes

The resources transferred to the states under these items have tended to increase partly because of the increase in these tax receipts and partly because of larger share in the divisible taxes assigned to the states. This has happened both in regard to income tax and excises. But a few questions have arrisen in

this regard which have not been solved as yet in spite of the attempts by the various Finance Commissions. One question is, whether origin of income or assessment as it has been specified recently, can have any weightage in the allocation of the divisible pool of income tax among the states. A number of arguments have been put forward favouring an assignment of weightage to this factor. But in a unified national economy going through a process of planned economic development, origin of income or assessment of income cannot be regarded as a rational factor in this regard and so no weightage should be given to it. The Finance Commissions have given a weightage, though a small one, to this factor simply to satisfy the claims of the industrialised states, but this has militated against the relatively less industrialised states for no fault of theirs.

Though the scope of Union excises now shared by the states has been extended to include all basic excises, the Finance Commissions have adopted an approach such as to allocate the excises among the states as also to serve as a balancing factor though not a significant one, in removing inter-regional resource disparities. This was the reason why the sixth Finance Commission gave a weightage to the distance in per capita income of a state from that of the per capita income of a state with higher than average national per capita in the distribution of the net proceeds of excises among the states. Such an approach is very welcome in a context where the different states of the Union stand at different levels of development. But the weightage given to production has tended to neutralise the above weightage because it has favoured the more industrialised states. The seventh Finance Commission made a further advance towards equalization in this regard.

The basic grievance of the states with regard to the distribution of divisible pool of income tax is that they have been deprived of a share in the corporation tax. The grievance of the states in this regard seems to be quite genuine. It is found that the rate of growth of revenues from corporation tax has been greater than that of income tax as indicated in the following figures:

(*Rs. in Crores*)

	1969-70	1973-74	1977-78
Income tax	448.5	745.2	1038.2
Corporation tax	353.4	582.6	1298.2

Not only the rate of increase of revenues from corporation tax has been greater, but the total revenues now realised from it are also higher than those from income tax. Therefore, if the states are given a share in the proceeds from corporation tax and even if their share in the joint proceeds of income and corporation tax is fixed lower, they will have the advantage of greater elasticity in their revenue resources. Corporate incomes increase at higher rates than individual incomes with the result that the proceeds of the tax on corporate income have a higher elasticity than those of the tax on individual incomes.

The basic consideration which should guide the allocation of resource from shared taxes to the states should be that the states should be assured of a stable and growing source of resources and should be effective partners in the elasticity of the Central resources.

Central Assistance for Financing State Plans

Under the existing arrangement in force which has begun in 1969-70 assistance to states to finance their plans is regulated by the Gadgil Formula. Previous to the Fourth Plan, while there was an agreed ceiling on aggregate Central assistance for State Plans, loans and grants within the ceiling was allocated, as far as possible, to specific schemes or heads of development. After the Central assistance had been allocated to specific schemes or heads of development, whatever remained of the agreed ceiling was extended as a miscellaneous development loan. At present in accordance with the Gadgil formula, the Planning Commission after a close scrutiny of the proposals of the states to raise additional resources to finance their plans, estimates the gap in their plan resources and this is filled up through Central financial assistance now given in the form of block loans and grants, assistance for Centrally sponsored and

Central schemes still continues to be related to specific schemes or programmes. In terms of this formula, 30 per cent of the assistance is made in terms of grants and 70 per cent in terms of loans. The total resources, thus allocated to a state are determined in terms of 60 per cent on the basis of population and of the remaining 40 per cent, 10 per cent on the basis of per capita income of a state, 10 per cent on the basis of per capita tax effort, 10 per cent on the basis of continuing major irrigation and power schemes and 10 per cent on the basis of special problems of particular states. Thus the specific merit of the formula is that it determines the quantum of financial assistance to a state on the basis of a few objective criteria.

But the states are not satisfied with the allocation of plan resources in terms of the Gadgil formula. They feel that the allocation of 70 per cent of the resources on the basis of loans places an unduly large burden on them and the present situation of the states' indebtedness to the Centre has arisen essentially out of this system of resource allocation. In the recent meeting of the Committee appointed by the National Development Council to examine the question of Central assistance to states for the Sixth Plan, some of the states pressed strongly for the revision of the present arrangement and went to the length of suggesting that 70 per cent of the allocation be made on the basis of grants and the remaining 30 per cent on the basis of loans. Some suggested it to be on 50:50 per cent basis.

The main consideration guiding the Planning Commission in allocating 70 per cent of the resources on the basis of loans is that since the resources are to be used by the states for financing schemes of development most of which would result in the creation of tangible assets which would generate a flow of income in future, it is logical to make such an allocation in the form of loans. The states' difficulties on this account have arisen because a substantial portion of these resources has been given as loans and advances to third parties which are not fully recovered and it is not sure how much of these loans given to third parties have led to the creation of tangible assets.

The states, however, have a case for the revision of the present arrangement of resource allocation since it has worked to their disadvantage and placed them in a difficult financial

position.

As regards the Gadgil formula, the dissatisfaction of the states has arisen on various grounds. It is argued by some states that it gives a large and disproportionate weightage to population of a state and population is not a satisfactory index of economic backwardness. A state may have a large population and still it may be quite a developed one economically and, therefore, if allocation of resources is made on the basis of population it will place a developed state in comparatively more advantageous position.

The remaining 40 per cent of the assistance is based upon four different criteria. But the formula in this regard is too cumbersome and does not give due weightage to economic backwardness since weightage of only 10 per cent is given to per capita income. In a developing economy the allocation of resources should be made to promote the rate of growth of the economy and the achievement of regional balance is an important aspect of the strategy of economic development in such an economy. Therefore, there is a strong justification for changing the present system of resource allocation based upon the Gadgil formula with a view to allocating larger resources to the economically less developed states in order to bring their level of development at par with that of the more developed states. In view of this the only appropriate criterion to distribute Central assistance among states for financing their plans is the per capita income of a state which is the only appropriate index of economic backwardness. As a result of the implementation of such a plan of allocation of Central assistance the economically less developed and backward states will be able to finance a plan of much larger size than what is practicable under the existing Gadgil formula and this will help them to exploit their resource potentials and to come up to the level of development of the advanced states in course of time. But at the same time, some weightage must be given to the relative tax efforts of states to raise resources. But however sound the criterion of per capita income may appear theoretically for the allocation of Central assistance to states, it may be difficult to get it accepted by all the states because some of the advanced states may have a grievance that this would put them at a disadvantageous position and slow down their rates of growth.

A system of federal finance is essentially based upon compromises, and therefore, if the criterion of per capita income is not accepted as the only criterion of resource allocation a compromise can be struck in which 40 per cent of the allocation can be made in terms of population, 50 per cent on the basis of per capita income and 10 per cent weightage may be given to the tax efforts of states. Such a scheme of resource allocation will have the merit of simplicity and the overriding objective of resource allocation will become the correction of regional disparities in development. At the same time, it will continue to give an incentive to the States to raise additional resources for financing their plans.

Non-Plan Financial Assistance

Apart from the grants recommended by the Finance Commission to make up the non-plan gaps in the revenues budgets of the states and the specific grant as recommended by the sixth Finance Commission for the upgradation of the essential administrative and social services in the states, the Union Government makes non-plan assistance to the states for other purposes also and these forms of assistance are largely discretionary in nature. This assistance has been for various purposes snch as loans for clearance of overdrafts, loans for meeting gaps in resources, loans for relief of distress caused by natural calamities, special accommodation loans, loan for relief and rehabilitation, loans in lieu of open market borrowings and small savings loans as well as a number of other miscellaneous loans. These loans are given largely on an *ad hoc* basis. The Central Government has also been giving non-plan grants to states for specific purposes such as for natural calamities.

The total non-plan loans from the Centre to the states during the last few years are shown below:

(*Rs. in Crores*)

	1975-76	*1976-77*	*1977-78*
Share of small savings	247-67	331.77	305.48
Others including ways and means advances	133.21	146.14	118.62
Total	380.90	477.91	424.10

Non-Plan Grants

		(*Rs. in Crores*)
1975-76	*1976-77*	*1977-78*
105.96	333.13	173.75

(Excluding statutory grants recommended by the sixth Finance Commission)

The above non-plan loans and grants are made without any objective criteria to guide them and therefore the states have grievances that their genuine needs are not satisfied and they have to approach the Centre every time when such an emergency situation arises.

It will be difficult to lay down specific criteria to determine these forms of non-plan assistance to the states. But some of these forms of assistance should have justifiably no occasion to arise such as for clearance of overdrafts. Occasions for overdrafts arise to meet the short-term gaps between states' revenues and expenditures. The overdrafts especially the unauthorised overdrafts availed by the states have been a subject of much concern. The question was examined by the fifth Finance Commission which maintained that no country with a unified currency system can afford to have more than one independent authority taking measures which result in increase of money supply. Unauthorised overdrafts run counter to this fundamental principle of sound monetary management.

The state governments, however, have been arguing in favour of these overdrafts on various grounds such as heavy incidence of payment of loans to the Government of India, escalation in costs of projects and other special factors. But as the sixth Finance Commission pointed out, whatever be the merits of these arguments, there can be no doubt that these overdrafts amount to a compulsory loan on the Government of India by the state governments.

The widespread concern about the dangerous consequences to the national economy of the continuing resort to overdrafts by certain states let the Government of India to take steps for orderly liquidation of overdrafts as they stood at the end of 1971-72. The essence of these arrangements was that subject to the state governments' agreeing to the repayment of

certain stipulated percentages of the outstanding overdrafts in 1972-73 and 1973-74, the Central government took over the responsibility for clearing the balance of the overdrafts through special medium term loans to the state governments. But since then some of the states have again been taking resort to these overdrafts from the Reserve Bank of India.

A solution of the problem of ways and means difficulties of the states should be found out in terms of such temporary accommodation being made entirely by the Government of India to states in the form of ways and means advances and the states should not be allowed access to the Reserve Bank for overdraft facilities. In our unified monetary system it is only the Union government which should have such access to the Reserve Bank for ways and means advances and the States' temporary difficulties should be mete out of the Union government's advances to them.

In the case of loans for financing of relief expenditure on natural calamities a national plan should be drawn up and implemented for prevention of floods and draught. This would progressively reduce the incidence of such calamities and so occasions for Central loans and grants on this ground would be progressively minimised.

Centralisation Vs Decentralisation

Recently arguments have been advanced from many quarters in India for a greater decentralisation of powers and functions in the hands of the states and subordinate units of administration such as Panchayats. The main thrust of these arguments is that greater decentralisation will give an added vitality and dynamism to our democratic institutions. It will make democracy more meaningful and promote the growth of the economy. But such arguments appear to have predominantly political overtones and do not appear to be convincing and acceptable on the basis of a closer analysis and examination.

The States have wide powers and functions as provided for in the constitution both in the spheres of economic development and administration of economic and social services. In the implementation of the states plans there is a scope for decentralised development in terms of the implementation of

local projects for which district and block plans should be drawn up and implemented by the district planning and block planning authorities. Decentralisation, if interpreted in this way, has a useful role to play in our process of planned development. But there is no question of the states being endowed with more administrative and developmental functions. Their powers and functions are already quite comprehensive. The only strong point in favour of decentralisation is that the states can have their planning process and techniques changed to involve the lower units of administration in it.

With regard to financial decentralisation there appears to be no scope for enlargement and extension of the taxing powers of the states. The states cannot be given independent powers of taxation of personal and corporate incomes since such incomes have to be taxed uniformly by the Central government. There can be no overlapping jurisdiction in this fiscal sphere in view of the experience of the U.S.A and other federations. The Union excises and customs have to be logically in the sphere of the Union government. The only case that can be justifiably built up for the states is to give them a larger share in Union excises and a share in corporation tax in terms of the existing constitutional arrangement which is basically very sound.

Conclusion

Thus the solution of the problems of state's finances does not lie in greater decentralisation of fiscal powers because this would lead to the fiscal system becoming more inefficient and complicated which will harm the process of growth of the economy. The solution lies in the states exploiting their own revenue potential to the full, in their achievement of better fiscal management and efficiency and in bringing about a system of resource allocation from the Centre to the states which fills up the gaps of unevenness in the context of a dynamic economy to bring about balanced regional development. The present system of federal finance in India has shown remarkable dynamism and adaptability and nothing should be done to disturb its basic structure and framework. The system has the potential and the flexibility to meet the changing needs of our developing economy.

The recent dissatisfaction which has arisen on the part of the states with regard to the allocation of resources can be redressed if the problem be approached in a proper spirit. There is no question of a conflict with regard to the sharing of resources between the Union and the States. The process of economic development of the country is essentially a co-operative endeavour in which both the Union and the states have to play their part united in the common objective of achieving the maximum use of these resources. The basic problem is that the rate of growth of the economy has not been what it was desired to be and the flow of resources in a developing economy is essentially a function of the rate of its economic growth.

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